

**DRAFT**  
**FINAL REPORT**  
**of the**  
**ADVISORY COMMITTEE**  
**on IMPROVEMENTS to**  
**FINANCIAL REPORTING**  
**to the**  
**UNITED STATES SECURITIES and**  
**EXCHANGE COMMISSION**

August [x], 2008

DRAFT - JULY 31

**Draft** Final Report  
of the  
Advisory Committee  
on Improvements to Financial Reporting  
to the  
United States Securities and Exchange Commission

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**SEC ADVISORY COMMITTEE ON  
IMPROVEMENTS TO FINANCIAL REPORTING**

Washington, DC 20549

August [x], 2008

The Honorable Christopher Cox  
Chairman  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1070

Dear Chairman Cox:

[It is my pleasure and privilege to present to you, and the other Commissioners, on behalf of the Advisory Committee on Improvements to Financial Reporting, our final report of recommendations to increase the usefulness of financial information to investors, while reducing the complexity of the financial reporting system to investors, preparers, and auditors.

Our Committee has worked diligently to provide this final report to you. This report reflects our final recommendations, which update the matters presented to you in our progress report dated February 14, 2008, based on additional deliberations and consideration of subsequent testimony and comment letters received. We believe the recommendations in our final report could be implemented by the Commission, the Financial Accounting Standards Board (FASB), the Public Company Accounting Oversight Board (PCAOB), or their respective staff, as appropriate, without legislation. These 25 recommendations are summarized in the executive overview of our final report.

We commend the Commission for its initiative in creating the Committee. You have been generous in furnishing staff and other resources. In particular, we would like to thank the staff members whose participation was invaluable during the Committee's work. These include from the Commission staff:

Conrad Hewitt	James Kroeker
John W. White	Shelley Parratt
Wayne Carnall	James Daly
Paul Beswick	Adam Brown
Bert Fox	Todd E. Hardiman
Stephanie Hunsaker	Shelly Luisi

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K. Ramesh  
Amy Starr  
Brett Williams

Nili Shah  
Dana Swain

These also include Russell Golden, Holly Barker, and Christopher Roberge from the FASB staff, and Sharon Virag, formerly with the PCAOB staff.

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We also want to thank our Official Observers whose participation and counsel have been so helpful to the Committee during this time:

Robert Herz, FASB  
Charles Holm, Federal Reserve Board  
Kristen Jaconi, U.S. Department of the Treasury  
Phil Laskawy, International Accounting Standards Committee Foundation  
Mark Olson, PCAOB

The members of the Committee, the Official Observers, and the staff are deeply grieved by the premature death of Brett Williams, who made such a great contribution to the Committee's work. We extend our sincere sympathies to Brett's family.

Respectfully submitted on behalf of the Committee,

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Robert C. Pozen  
Committee Chairman

cc: [Current Commissioners - to be updated]  
Members and Official Observers of the Committee  
Conrad Hewitt  
John White  
James L. Kroeker  
Florence E. Harmon]

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## EXECUTIVE OVERVIEW

### I. Introduction

In July 2007, the U.S. Securities and Exchange Commission (SEC or Commission) chartered the Advisory Committee on Improvements to Financial Reporting (Committee). The Committee's dual mandate was to examine the U.S. financial reporting system in order to make recommendations intended to increase the usefulness of financial information to investors,<sup>1</sup> while reducing the complexity of the financial reporting system to investors, preparers, and auditors. Reflecting this dual mandate, the Committee included 17 members representing key constituencies in our capital markets.<sup>2</sup> The diverse backgrounds and experiences of the members included five important users of financial statements, four former regulators (of whom one is a full-time academic), three chief financial officers from companies of different sizes, the chief executive officers of a large- and a medium-sized audit firm, and three members of audit committees.<sup>3</sup>

At the start of our work, the Committee agreed to issue focused recommendations, addressing acknowledged problem areas, that we believed could be adopted in a reasonable time period by the SEC, the FASB, or the Public Company Accounting Oversight Board (PCAOB). We agreed to avoid recommendations requiring legislative action or attempting to address all perceived shortcomings in the financial reporting system. In doing our work, we were guided by the principle that the primary purpose of financial statements is to help investors make well-informed decisions.

At our July 11, 2008 meeting, all Committee members present unanimously adopted all of the recommendations in this report. [At our July 31, 2008 meeting, we voted unanimously to issue to the Chairman of the SEC this final report of the Committee's recommendations to the SEC to improve financial reporting.<sup>4</sup>] This report is the culmination of our work, which has included eight public meetings where these topics

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<sup>1</sup> We define "investors" as all providers of capital, including current and potential providers of equity capital and creditors. We recognize there are other important users of financial statements, such as credit rating agencies.

<sup>2</sup> Each member's representative capacity is identified in appendix D.

<sup>3</sup> One of these audit committee members is also a former chairman and chief executive officer of a large audit firm. Another audit committee member is also a full-time academic and a former chairman of the Financial Accounting Standards Board (FASB or Board).

<sup>4</sup> In our role as an advisory committee to the SEC, we have addressed most of our recommendations to the SEC, while noting the need for involvement of other bodies, such as the FASB and the PCAOB. We also note that some of our recommendations may require SEC action, while others may be implemented by SEC staff. We have, however, generally adopted a convention of addressing these areas to the SEC for convenience. We leave the determination of whether the proposals require SEC or SEC staff action to the discretion of the SEC and its staff. This report does not necessarily reflect the views or regulatory agenda of the SEC or its staff.

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were deliberated by the full Committee. In addition, to facilitate the development of our recommendations, our four subcommittees researched, deliberated, and sought views from various constituents, in order to prepare proposals for consideration by the full Committee. In generating this report, we also considered all of the public comment letters received on our work and public testimony received in March and May 2008.<sup>5</sup>

This final report is organized by the topics considered by our four subcommittees. Thus, chapter 1 is on substantive complexity, chapter 2 on the standards-setting process, chapter 3 on audit process and compliance, and chapter 4 on delivering financial information.

## **II. Scope of Our Report**

We have limited our deliberations to matters involving SEC registrants. While financial reporting matters and, more specifically, generally accepted accounting principles in the U.S. (U.S. GAAP), also apply to private companies and non-profit entities, our focus is consistent with our role as an advisory committee to the SEC.

We have also limited our scope as it relates to international matters. We broadly support the continued move to a single set of high-quality global accounting standards, coupled with enhanced international coordination to foster their consistent interpretation and to avoid jurisdictional variants. Further, we encourage the development of a roadmap to identify issues and milestones to transition to this end state in the U.S., with sufficient time to minimize disruptions, resource constraints, and the complexity arising from such a significant change.<sup>6</sup>

We note that the SEC and the FASB are now engaged deeply in efforts with many parties across the world on a variety of complex issues related to the convergence<sup>7</sup> of U.S. GAAP with international financial reporting standards (IFRS). Accordingly, the Committee has decided not to focus directly on convergence issues. However, we recognize that there are various paths to convergence, and that a full transition may take

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<sup>5</sup> Comments to the Committee are available at <http://www.sec.gov/comments/265-24/265-24.shtml>. Verbal testimony is available via archived webcasts and records of proceedings at <http://www.sec.gov/about/offices/oca/acifr.shtml>.

<sup>6</sup> See, Chairman Christopher Cox, *Making Disclosure More Useful for Public Company Directors*, Keynote Address to the Stanford Law School Directors' College, Palo Alto, CA, (June 23, 2008).

<sup>7</sup> Some constituents understand "transition" or "convergence" to mean that U.S. GAAP and IFRS (as issued by the International Accounting Standards Board (IASB)) will eventually be harmonized, at which point no substantive differences will exist between the two bodies of accounting literature. Others understand it to mean a discrete transition from U.S. GAAP to IFRS at a specified date without respect to whether the two bodies of literature are substantially harmonized at the date of transition. We use these terms broadly and interchangeably to refer to the movement from the current financial reporting system in the U.S. to its ultimate end state, without endorsement of the specific approach to do so.

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years to achieve. Therefore, we believe that it is quite fruitful to recommend enhancements to the current financial reporting system in the U.S.

Generally, we believe that the principles underlying our recommendations to improve the standards-setting process would be relevant to any accounting standards-setter. However, we recognize that the application of these principles and other specific recommendations could be impacted by the path and pace of convergence to international accounting standards in the U.S. For example, in principle we note that accounting standards should be based on business activity, rather than industry-specific guidance and that GAAP should contain few alternatives. In application, we observe that any joint or separate projects completed by the FASB should be based on business activity. However, our recommendation that the FASB eliminate existing industry-specific GAAP that conflicts with generalized U.S. GAAP is dependent upon the ultimate path and pace of convergence in the U.S.

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### **III. Key Recommendations**

This executive overview highlights the key aspects of the Committee's recommendations, with a few examples,<sup>8</sup> linking these recommendations with the Committee's dual mandate of improving usefulness and reducing complexity in financial reporting. A compendium of the Committee's final recommendations is included at the end of this executive overview. This section of the executive overview outlines five themes underlying the Committee's recommendations in this final report:

- A. Increasing the usefulness of information in SEC reports
- B. Enhancing the accounting standards-setting process
- C. Improving the substantive design of new accounting standards
- D. Delineating authoritative interpretive guidance
- E. Clarifying guidance on financial restatements and accounting judgments

#### **III.A. Increasing the Usefulness of Information in SEC Reports**

One of our primary objectives is to make financial information more useful to investors, both individuals and institutions, while minimizing additional burdens on preparers. As part of this effort, we are recommending a short executive summary at the beginning of a company's annual report on Form 10-K (with material updates in quarterly reports on Form 10-Q). Many individual investors may find a company's periodic reports overly complex and detailed. A summary would describe concisely the most important themes or other significant matters with which management is primarily concerned, along with a page index showing where investors could find more detailed information on particular subjects.

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<sup>8</sup> The examples we use are illustrative only; we do not mean to imply any order of priority.

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These executive summaries would appear in the forepart of these financial reports, whether on company websites or in hard copies of the reports. In addition, in our view, summary information on corporate websites allows investors to obtain an overview of the company's financial performance, with hyperlinks to allow more detailed reviews of any particular area. To promote greater use of corporate websites, we urge the SEC to provide additional guidance on certain legal issues through an updated interpretive release regarding the use of electronic media. We are pleased to note that the SEC has voted to publish an interpretative release to provide this guidance.

We support the SEC's long-term efforts to data tag financial reports using eXtensible Business Reporting Language (XBRL), so that particular items across companies can be easily sorted and analyzed by investors. Similarly, we support the gradual phase-in of XBRL, which was generally included in the SEC's recent proposal. The SEC proposal further follows generally our recommendation to have XBRL tags initially furnished (rather than filed) by companies, without a separate attestation report on these tags by the auditors.

We are also encouraging the private sector to develop key performance indicators (KPIs), on an activity and industry basis, that would capture important aspects of a company's activities that may not be fully reflected in its financial statements or may be non-financial measures. In our view, KPIs are likely to provide investors with an enhanced understanding of company performance, so this is a fruitful area for encouraging further uniformity and disclosure. While we recognize that the most appropriate KPIs may be dependent on the activities of the particular company, we would like the private sector to develop consistent definitions and methodologies for KPIs by activity and industry, as appropriate, in order to facilitate comparisons across companies and through time.

### **III.B. Enhancing the Accounting Standards-Setting Process**

Although the FASB's processes work well and it recently made significant improvements to these processes, further refinements could enhance the effectiveness and efficiency of standards-setting. Most importantly, we believe that the financial reporting system would be best served by recognizing the pre-eminence of the perspective of investors because they are the primary users of financial reports. To promote this perspective, we support increased investor representation on the FASB and the Financial Accounting Foundation (FAF). Increasing their direct and indirect representation in the process is the best way to assure that financial reports will be useful to investors.

While the FASB has an extensive process for soliciting feedback from investors and other interested parties on proposed standards, this process would be improved by increasing the field work for proposed standards and formalizing post-adoption reviews of new standards, as well as periodic assessments of existing standards. These measures

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are designed to provide the FASB with better input during and after the standards-setting process, which should enhance the effectiveness of the process and make the end product more useful to investors.

To be responsive to the ever-changing financial landscape, key participants in our financial reporting process need to have a high degree of communication and coordination of their activities. To increase this communication and coordination, we recommend the creation of a Financial Reporting Forum (FRF), on which key public and private parties would be represented. The FRF would meet regularly to discuss the current pressures on the financial reporting system and how constituents are meeting these challenges.

### **III.C. Improving the Substantive Design of New Accounting Standards**

Certain accounting standards do not clearly articulate their underlying objectives and principles; these are sometimes obscured by dense language, detailed rules, and numerous exemptions. In response, we are suggesting a different approach to the design of standards in a few important areas.

We support the objective of the FASB's project on financial statement presentation to divide a company's individual financial statements into cohesive components. We recognize the current mixed attribute system of historic cost and fair value is likely to continue, although we urge a judicious approach to further expansions of fair value. Within this mixed attribute system, it would be very helpful to portray for investors the different sources of changes in a company's income – for example, by clearly distinguishing cash receipts from unrealized changes in fair value. In our view, this distinction would also help companies **better** explain to investors earnings volatility each period.

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We generally oppose all-or-nothing bright-line tests since some of them may result in very different accounting for transactions with quite similar economics. A number of these tests are also susceptible to manipulation, which the leasing rules illustrate well. Instead, we advocate intermediate approaches such as proportionate recognition,<sup>9</sup> consideration of qualitative factors, and enhanced disclosures to more fairly present a company's financial condition and operating results. Each of these approaches might be fruitfully considered, for example, as part of the accounting reforms under discussion for off-balance-sheet financing vehicles.

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<sup>9</sup> We define proportionate recognition to mean accounting for one's rights and obligations as a party to a contract, as discussed in chapter 1.

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To decrease complexity and increase comparability, we are generally advocating a move away from industry-specific guidance in authoritative literature – unless justified by strong conceptual arguments. A better approach would be to focus on the nature of the business activity itself, since the same activities, such as lending, may be carried out by companies from different industries. In our view, the FASB should begin by addressing industry-specific guidance that conflicts with the general principles in U.S. GAAP. We also recommend that the FASB eliminate alternative accounting methods for the same transaction, unless the alternative has a compelling rationale.

#### **III.D. Delineating Authoritative Interpretive Guidance**

Historically, interpretive guidance on implementing accounting standards proliferated from many public and private sources, thus increasing the volume of U.S. GAAP. To reduce the avoidable complexity associated with the proliferation of U.S. GAAP, we strongly support the FASB's efforts to complete the codification of all U.S. GAAP in one document, which would clearly delineate authoritative from non-authoritative literature. Further, to help integrate SEC accounting guidance into this codification, the SEC should formulate its guidance in a format consistent with the one used by the FASB. While we recognize that non-authoritative interpretive implementation guidance will continue to be promulgated by various sources and to play a useful role, we recommend that such guidance be prominently labeled as non-authoritative to avoid confusion. If the convergence of U.S. GAAP and IFRS does not occur within a few years, the FASB and the SEC should consider a systematic rethinking of U.S. GAAP in a second phase of the codification project.

We believe that there should be a single standards-setter for all authoritative accounting standards and interpretive implementation guidance of general significance. The FASB should perform this function for U.S. GAAP, while the SEC should focus on registrant-specific guidance as explained below. If the SEC staff identifies accounting issues of relatively broad significance in the process of reviewing filings by registrants, the SEC staff should refer such issues to the FASB through the proposed FRF. In those rare instances when the SEC staff believes it is necessary to quickly announce an accounting interpretation of broad significance, we strongly encourage the SEC to inform the FASB Chairman in advance of such interpretations.

We support the efforts of the SEC staff in its Division of Corporation Finance to publish its comment letters on financial reports filed by registrants. However, we urge the SEC staff to re-emphasize that those comment letters are registrant-specific and do not represent binding precedent on other registrants. Similarly, we urge the Division of Corporation Finance and the Office of the Chief Accountant to emphasize that their “pre-clearance” processes are registrant-specific and are not binding on other registrants. We also support a number of steps that we understand the SEC staff is planning to take to increase the consistency of its accounting guidance to registrants.

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### **III.E. Clarifying Guidance on Financial Restatements and Accounting Judgments**

In 2006, more than 9% of all U.S. public companies restated their financial statements because of accounting errors. Although the number of restatements appears to have started to decline, the number is still quite high. Moreover, there is considerable evidence that the accounting errors leading to financial restatements were less significant in the last few years than in the period before 2002. The restatement process, which may take longer than 12 months, imposes significant costs on investors as well as preparers. During that process, companies normally go into a “dark period” and issue very little financial information to the public.

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Therefore, we recommend that the determination of whether an accounting error is material be separated from the decision on how to correct the error. We support a stricter rule than the current practice on accounting errors; a company should promptly correct and prominently disclose any accounting error unless clearly insignificant. In addition, the instructions to the SEC’s Form 8-K should make clear that it must be filed for all determinations of non-reliance on prior financial statements to limit the possibility of “stealth” restatements. On the other hand, the correction and disclosure of any accounting error should not automatically result in a financial restatement. Due to the high probable cost to investors during the “dark period,” prior period financial statements should only be amended if the error would be material to investors making current investment decisions.

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The preparation and audit of financial statements have always required the exercise of judgment. The recent trend in accounting entails a move away from prescriptive guidance toward greater use of judgment – for example, the more frequent use of fair value involves estimates of value that may be less objectively determined than historical cost measures. Similarly, the revised auditing standard applicable to audits of internal control over financial reporting, issued by the PCAOB last year, emphasizes the need for professional judgment in taking a risk-based approach to performing internal control audits. Moreover, international accounting standards generally contain less prescriptive guidance and more reliance on general principles than U.S. GAAP.

In recognition of the increasing exercise of accounting and audit judgments, we recommend that the SEC and PCAOB adopt policy statements on this subject. These policy statements would provide more transparency into how these regulators evaluate the reasonableness of a judgment. We have offered factors that we believe are important in this evaluation process, including the available alternatives a company identified; the robustness of a company’s analysis of the relevant literature and review of the pertinent facts; the degree to which a company’s approach is consistent with current accounting practice; and how a company’s conclusions meet investors’ information needs. Further,

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we believe that the statement of policy should emphasize that judgments be documented contemporaneously to ensure that the evaluation of the judgment is based on the same facts that were reasonably available at the time the judgment was made. We believe that adoption of these policy statements would not only provide more transparency into how the SEC and the PCAOB evaluate the reasonableness of a judgment, but also encourage preparers and auditors to follow a disciplined process in making judgments. As a result, investors should have more confidence in the ways in which accounting and auditing judgments are being exercised.

#### **IV. Compendium of Recommendations**

In this final report, the Committee makes the following recommendations – organized according to the four chapters of the report. Each recommendation is discussed in more detail in the body of this report.

##### ***Chapter 1 – Substantive Complexity***

1. **Recommendation 1.1:** Avoidable complexity caused by the mixed attribute model should be reduced in the following respects:
  - Measurement framework – The SEC should recommend that the FASB be judicious in issuing new standards and interpretations that expand the use of fair value in areas where it is not already required<sup>10</sup> until:
    - The FASB completes a measurement framework to systematically assign measurement attributes to different types of business activities
    - The SEC, the FASB, and other regulators and standards-setters develop and implement a plan to strengthen the infrastructure that supports fair value reporting.
  - Financial statement presentation<sup>11</sup> – The SEC should recommend that the FASB consider the merits of:
    - Assigning a single measurement attribute within each business activity to the maximum extent feasible, which is consistent across the financial statements<sup>12</sup>

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<sup>10</sup> For instance, improvements to certain existing, particularly complex standards, such as SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, may be warranted in the near-term. Similarly, this recommendation is not intended to delay the revision of standards that currently employ fair value measurement, such as those relating to pension and lease accounting.

<sup>11</sup> We are aware of the FASB and IASB's joint financial statement presentation project and support its objective of dividing a company's individual financial statements into cohesive components.

<sup>12</sup> To make this approach operational, the FASB might establish a rebuttable presumption in favor of a single measurement attribute within each appropriate section. For example, if business activities were

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- Aggregating financial statements by meaningful categories of business activities, such as the operating, investing, and financing sections
  - Developing a practical means for reconciling the statements of income and cash flows by major classes of measurement attributes.<sup>13</sup>
2. Recommendation 1.2: The SEC and the FASB should work together to develop a disclosure framework to:
- Integrate existing SEC and FASB disclosure requirements into a cohesive whole to ensure meaningful communication and logical presentation of disclosures, based on consistent objectives and principles. This would eliminate redundancies and provide a single source of disclosure guidance across all financial reporting standards.
  - Require disclosure of the principal assumptions, estimates, and sensitivity analyses that may impact a company's business, as well as a qualitative discussion of the key risks and uncertainties that could significantly change these amounts over time. This would encompass transactions recognized and measured in the financial statements, as well as events and uncertainties that are not recorded.
3. Recommendation 1.3: The SEC and FASB should also establish a process of coordination for the Commission and the FASB to regularly assess the continued relevance of disclosure guidance in both bodies of literature, particularly as new FASB standards are issued. Existing guidance should be updated or removed, as appropriate.<sup>14</sup>
4. Recommendation 1.4: Recognition guidance in U.S. GAAP should be based on a presumption that bright lines should not exist. As such, the SEC should recommend that the recognition guidance in new projects undertaken jointly or separately by the FASB avoid the use of bright lines, in favor of proportionate recognition. Where proportionate recognition is not feasible or applicable, the FASB should provide
- 

grouped into operating, investing, and financing sections, the Board may determine amortized cost is the presumptive measurement attribute within the operating section of a company's financial statements. Nevertheless, the Board would also have to consider whether fair value is appropriate for financial assets and liabilities employed in those business activities, such as certain derivative contracts used to hedge commodity price risk for materials used in the production process.

<sup>13</sup> Before adopting this reconciliation, we believe the FASB should conduct in-depth field work to fully understand the benefits it provides to users, as well as the added burden it creates for preparers and auditors. This should also help the FASB determine whether the reconciliation should be presented as a new primary financial statement or as a footnote disclosure. An example of this presentation is included in chapter 1.

<sup>14</sup> We consider coordination between the SEC and the FASB in chapter 2. For example, see recommendation 2.3 regarding the periodic assessment of existing accounting and related disclosure standards.

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qualitative factors in its recognition guidance. Finally, enhanced disclosure should be used as a supplement or alternative to the two approaches above.

Any new projects should also include the elimination of existing bright lines in the recognition guidance of relevant areas to the extent feasible as a specific objective of those projects, in favor of the two approaches above.

5. Recommendation 1.5: Constituents should be better trained to consider the economic substance and business purpose of transactions in determining the appropriate accounting, rather than relying on mechanical compliance with rules. As such, the SEC should undertake efforts to, and also recommend that the FASB, academics, and professional organizations, better educate students, investors, preparers, auditors, and regulators in this respect.
6. Recommendation 1.6: U.S. GAAP should be presumptively based on business activities, rather than industries. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB be scoped on the basis of business activities, except in rare circumstances. Any new projects should include the elimination of existing industry-specific guidance—particularly that which conflicts with generalized U.S. GAAP—in relevant areas as a specific objective of those projects, except in rare circumstances.  
  
Considering the pace of convergence efforts, the SEC should also recommend that in conjunction with its current codification project, the FASB add a project to its agenda to eliminate existing industry-specific guidance which conflicts with generalized U.S. GAAP, except in rare circumstances.
7. Recommendation 1.7: U.S. GAAP should be based on a presumption that formally promulgated alternative accounting policies should not exist. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB not provide additional optionality, except in rare circumstances. Any new projects should also include the elimination of existing alternative accounting policies in relevant areas as a specific objective of those projects, except in rare circumstances.
8. Recommendation 1.8: U.S. GAAP should be scoped with sufficient precision to minimize the use of scope exceptions. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB be carefully scoped to minimize the use of exceptions. Any new projects should also seek to refine the scope of existing standards in relevant areas as a specific objective of those projects to minimize existing scope exceptions.

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9. Recommendation 1.9: U.S. GAAP should be based on a presumption that similar activities should be accounted for in a similar manner. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB should not create additional competing models, except in rare circumstances. Any new projects should also include the elimination of competing models in relevant areas as a specific objective of those projects, except in rare circumstances.

### *Chapter 2 – Standards-Setting Process*

10. Recommendation 2.1: Investor perspectives are critical to effective standards-setting, as investors are the primary consumers of financial reports. Only when investor perspectives are properly considered by all parties does financial reporting meet the needs of those it is primarily intended to serve. Therefore, investor perspectives should be given pre-eminence<sup>15</sup> by all parties involved in standards-setting. Although it is more challenging to obtain investor perspectives than those of other constituents involved in the standards-setting process, additional investor representation would facilitate increased consideration of investor perspectives in the standards-setting process. Specifically, the SEC should recommend that the FAF and the FASB do the following:
- Add investors to the FAF to give more weight to the views of different types of investors, both large and small
  - Give more representation on both the FASB and the FASB staff to experienced investors to improve consideration of the usefulness of financial reports
  - Re-evaluate the manner, timing, and quality of investor input received throughout standards-setting to determine whether changes would be warranted to make investor involvement more efficient and effective.
11. Recommendation 2.2: The SEC should continue to recommend that the FAF enhance governance of the FASB, as follows:
- Recommend that the FAF amend the FASB’s mission statement, stated objectives, and precepts to emphasize that an additional goal should be to minimize avoidable complexity
  - Recommend that the FAF develop performance metrics to ensure that key aspects of the standards-setting process are effective, efficient, and compliant with the goals in the FASB’s mission statement, objectives, and precepts.

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<sup>15</sup> [We recognize the need for balance among all parties involved in the standards-setting process. We do not intend to suggest by this recommendation that investor input trumps all others. Instead, in cases where constituent views cannot be reconciled, we believe that the investor perspective should be afforded greater weight.]

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12. Recommendation 2.3: The SEC should recommend that the FAF, the FASB, and other participants in the financial reporting system continue to improve the effectiveness, efficiency, and timeliness of standards-setting, as follows:
- Create an FRF that includes key constituents from the preparer, auditor, and investor and other user communities, to meet with representatives from the SEC, the FASB, and the PCAOB to discuss pressures in the financial reporting system overall, both immediate and long-term, and how individual constituents are meeting these challenges. This may require the FASB to re-evaluate the roles and composition of other advisory groups or agenda committees.
  - Enhance the consistency and transparency of key aspects of the FASB's field work, including cost-benefit analyses, field visits, and field tests.
  - Formalize post-adoption reviews of each significant new standard to address interpretive questions and reduce the diversity of practice in applying the standard, if needed.
  - Formalize periodic assessments of existing accounting and related disclosure standards to keep them current.
13. Recommendation 2.4: The SEC should coordinate with the FASB to clarify roles and responsibilities regarding the issuance of interpretive implementation guidance, as follows:
- To the extent practicable, going forward, there should be a single standards-setter for all authoritative accounting standards and interpretive implementation guidance that are applicable to a particular set of accounting standards, such as U.S. GAAP or IFRS. For U.S. GAAP, the FASB serves this function. To that end, the SEC should only issue broadly applicable interpretive implementation guidance in limited situations (see recommendation 2.5).
  - The FASB Codification, a draft of which was released for verification on January 16, 2008, should be completed in a timely manner. In order to fully realize the benefits of the FASB's codification efforts, the SEC should ensure that the literature it deems to be authoritative is integrated into the FASB Codification by following, to the maximum extent practicable, a format consistent with the one used by the FASB.
  - All other sources of interpretive implementation guidance should be considered non-authoritative and should not be required to be given more credence than any other non-authoritative sources that are evaluated using reasonable judgments made in good faith that are supportable under U.S. GAAP.
  - The proposed FRF should advise the FASB on re-prioritizing its agenda in a way that balances the need for international convergence (which is highly dependent on possible future actions of the SEC), improvements to the conceptual framework, and maintaining existing U.S. GAAP. If U.S. GAAP will continue to be in use for an extended period of time, such a re-prioritization of standards-

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setting should consider the possibility of a second phase of the codification project to systematically revisit U.S. GAAP.

14. Recommendation 2.5: As a general matter, the SEC staff should refrain from issuing broadly applicable interpretive implementation guidance that would change U.S. GAAP and instead should refer such matters to the FASB, such as through the proposed FRF. The SEC staff should re-emphasize that its comment letter and “pre-clearance” processes are registrant-specific; other registrants should not necessarily change their accounting because they become aware of another comment letter, unless they conclude, on their own, that it is appropriate to do so. Furthermore, the SEC staff is taking a number of steps to improve the consistency of its interpretive implementation guidance associated with U.S. GAAP and the Commission should take appropriate steps to monitor the outcome of those actions.
15. Recommendation 2.6: The SEC should recommend that the FASB build upon recent improvements made to the design of accounting standards as part of its Understandability initiative – primarily by increasing the use of clearly-stated objectives, outcomes, and principles, and emphasizing the importance in financial reporting of being responsive to investor and other user needs for clarity, transparency, and comparability, while seeking to capture the economic substance of transactions to the extent feasible.

### ***Chapter 3 – Audit Process and Compliance***

16. Recommendation 3.1: The FASB or the SEC, as appropriate, should supplement existing guidance to reinforce the following concepts:
  - Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor
  - Materiality should be judged based on how an error affects the total mix of information available to a reasonable investor, including through a consideration of qualitative and quantitative factors.

The FASB or the SEC, as appropriate, should also conduct both education sessions internally and outreach efforts to financial statement preparers and auditors to raise awareness of these issues and to promote a more consistent application of the concept of materiality.

17. Recommendation 3.2: The FASB or the SEC, as appropriate, should issue guidance on how to correct an error consistent with the principles outlined below:
  - Companies should be required to promptly correct all errors, excluding clearly insignificant errors, and should make appropriate disclosure about prior period errors that are corrected in the current period. Companies should not have the option to defer correction of errors until future financial statements.

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- Prior period financial statements should only be restated for errors that are material to those prior periods.
  - The determination of how to correct a material error should be based on the needs of investors making current investment decisions. For example, a material error that is not important to a current investment decision would not require restatement of the financial statements in which the error occurred, but would need to be promptly corrected and prominently disclosed in the current period.
  - There may be no need for the filing of amendments to previously filed annual or interim reports to reflect restated financial statement, if the next annual or interim period report is being filed in the near future and that report will contain all of the relevant information.
  - Restatements of interim periods do not necessarily need to result in a restatement of an annual period.
  - Corrections of large errors in previously issued financial statements should always be disclosed in the filing in a prominent manner, even if the error is determined not to be material.<sup>16</sup>
  - To limit the likelihood of “stealth restatements,” the SEC should revise the instructions to Form 8-K to state clearly that the form needs to be filed for all determinations of non-reliance on prior financial statements.
18. Recommendation 3.3: The FASB or the SEC, as appropriate, should issue guidance on disclosure of financial and other reliable information during the period during which the impact of a financial reporting error is being evaluated or the restatement is being prepared, about the need for the restatement and about the restatement itself to improve the adequacy of this disclosure based on the needs of investors.
19. Recommendation 3.4: The FASB or the SEC, as appropriate, should develop and issue guidance on applying materiality to errors identified in prior interim periods and how to correct these errors. This guidance should reflect the following principles:
- Materiality in interim period financial statements must be assessed based on the perspective of the reasonable investor
  - When there is a material error in an interim period, the guidance on how to correct that error should be consistent with the principles outlined in recommendation 3.2.
20. Recommendation 3.5: The SEC should issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments and include factors that it

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<sup>16</sup> Whatever manner is chosen by a company for prominent disclosure of the correction of an accounting error, such disclosure of corrected errors should be included in the notes to the company’s financial statements (delineated as such to the extent feasible) in order to preserve the record from period to period.

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considers when making this evaluation. The PCAOB should also adopt a similar approach with respect to auditing judgments.

The statement of policy applicable to accounting-related judgments should address the choice and application of accounting principles, as well as estimates and evidence related to the application of an accounting principle. We believe that a statement of policy that is consistent with the principles outlined in this recommendation to cover judgments made by auditors based on the application of PCAOB auditing standards would be beneficial to auditors. Therefore, we recommend that the PCAOB develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards. The PCAOB's statement of policy should acknowledge that the PCAOB would look to the SEC's statement of policy to the extent the PCAOB would be evaluating the appropriateness of accounting judgments as part of an auditor's compliance with PCAOB auditing standards.

We believe that it would be useful if the SEC also set forth in the statement of policy factors that it looks to when evaluating the reasonableness of preparers' accounting judgments.

#### ***Chapter 4 – Delivering Financial Information***

21. **Recommendation 4.1:** The SEC should, over the long-term, mandate the filing of interactive data-tagged financial statements after the satisfaction of certain preconditions relating to: (1) successful XBRL U.S. GAAP Taxonomy testing, (2) the capacity of reporting companies to file interactive data-tagged financial statements using the new XBRL U.S. GAAP Taxonomy on the SEC's EDGAR system, and (3) the ability of the EDGAR system to provide an accurately rendered version of all such tagged information. The SEC should phase-in interactive data-tagged financial statements as follows:
- The largest 500 domestic public reporting companies based on unaffiliated market capitalization (public float) should be required to furnish to the SEC, as is the case in the voluntary program today, a document prepared separately from the reporting companies' financial statements that are filed as part of their periodic Exchange Act reports. This document would contain the following:
    - Interactive data-tagged face of the financial statements<sup>17</sup>
    - Block-tagged footnotes to the financial statements.<sup>18</sup>

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<sup>17</sup> To allow this first phase, the SEC EDGAR system must permit submissions using the new XBRL U.S. GAAP Taxonomy.

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- Domestic large accelerated filers (as defined in SEC rules, which would include the initial 500 domestic public reporting companies) should be added to the category of companies, beginning one year after the start of the first phase, required to furnish interactive data-tagged financial statements to the SEC.

Once the preconditions noted above have been satisfied and the second phase-in period has been implemented, the SEC should evaluate whether and when to move from furnishing to the SEC interactive data-tagged financial statements to the official filing of such financial statements with the SEC for the domestic large accelerated filers, as well as the inclusion of all other reporting companies, as part of a company's Exchange Act periodic reports.<sup>19</sup>

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22. **Recommendation 4.2:** The SEC should issue a new comprehensive interpretive release regarding the use of corporate websites for disclosures of corporate information, which addresses issues such as liability for information presented in a summary format, treatment of hyperlinked information from within or outside a company's website, treatment of non-GAAP financial disclosures and GAAP reconciliations, and clarification of the public availability of information disclosed on a reporting company's website.

Industry participants, including investors, should coordinate among themselves to develop uniform best practices on uses of corporate websites for delivering corporate information to investors and the market.

23. **Recommendation 4.3:** The SEC should encourage private sector initiatives targeted at best practice development of company use of KPIs in their business reports. The SEC should encourage private sector dialogue, involving preparers, investors (including analysts), and other interested industry participants, such as consortia that have long supported KPI-like concepts, to generate understandable, consistent, relevant, and comparable KPIs on relevant activity and, as appropriate, industry-specific, bases. The SEC also should encourage companies to provide, explain, and consistently disclose period-to-period company-specific KPIs. The SEC should consider reiterating and expanding its interpretive guidance regarding disclosures of KPIs in management's discussion and analysis (MD&A) and other company disclosures.

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<sup>18</sup> We understand that tagging beyond the face of the financial statements and block-tagging of footnotes, such as granular tagging of footnotes and non-financial data, may require significant effort and would involve a significant number of tags.

<sup>19</sup> A dissenting vote on developed proposal 4.1 was cast by Peter Wallison in February 2008.

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24. Recommendation 4.4. Industry groups, including the National Investor Relations Institute, Financial Executives International, and the CFA Institute should update their best practices for earnings releases. Such updated best practices guidance should cover, among other matters, the type of information that should be provided in earnings releases and the need for investors to receive information that is consistent from quarter to quarter, with an explanation of any changes in disclosures from quarter to quarter. Further, the best practices guidance should consider recommending that companies include in their earnings releases their condensed financial statements (including income statement, balance sheet, and cash flow tables); locate GAAP reconciliations in close proximity to any non-GAAP financial measures presented; and provide more industry- and company-specific key performance indicators.

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The SEC should consider restating its view that website disclosures regarding GAAP reconciliations for non-GAAP financial measures presented in connection with earnings calls be available on such sites for at least 12 months.

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25. Recommendation 4.5: The SEC should mandate the inclusion of an executive summary in the forepart of a reporting company's filed annual report on Form 10-K that will provide a roadmap to the fuller discussion in the report. In filed quarterly reports on Form 10-Q, the executive summary would provide material updates to the executive summaries in the annual or prior quarterly reports. The executive summary should provide summary information, in plain English, in a narrative and perhaps tabular format of the most important information about a reporting company's business, financial condition, and operations, and provide the context for the disclosures contained in the annual report. As with the MD&A, the executive summary should be a concise and balanced discussion that identifies the most important themes or other significant matters with which management is primarily concerned. The executive summary should be required to use a layered approach that would present information in a manner that emphasizes the most important information about the reporting company and include cross-references to the location of the fuller discussion in the annual report. To the extent a similar summary may otherwise be included or useful elsewhere in the report, such as in MD&A, the subsequent section would not need to replicate the discussion, but instead could cross-reference such executive summary. The summary should include page number references to more detailed information contained in the document (which, if the report is provided electronically, could be hyperlinks). The executive summary should be required for all filers, although we believe that the best approach would be to start with executive summaries for large companies and then gradually phase-in executive summaries for smaller public companies.

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We believe publication of this report will increase the likelihood of our recommendations being implemented. We have made great efforts to solicit public input at every stage of the Committee's deliberations, and to work closely with the staff of the SEC, the FASB, and the PCAOB. We are hopeful that, through the cooperation of all relevant parties, this report will expeditiously and significantly improve the state of financial reporting in the U.S.

DRAFT - JULY 31

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## INTRODUCTION

### I. Our Formation

On June 27, 2007, U.S. Securities and Exchange Commission (SEC or Commission) Chairman Christopher Cox announced the Commission's intent to establish the SEC Advisory Committee on Improvements to Financial Reporting (Committee).<sup>20</sup> At the same time, Robert C. Pozen was named Chairman of the Committee. The official notice of our establishment was published in the Federal Register five days later.<sup>21</sup> The Committee's charter was filed with the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services on July 17, 2007, initiating our 12 ½-month existence.<sup>22</sup> The Committee's membership was completed on July 31, 2007, with members drawn from a wide range of professions, backgrounds, and experiences.<sup>23</sup> On August 2, 2007, we adopted our by-laws.<sup>24</sup>

### II. Our Objectives

The Committee's dual mandate was to examine the U.S. financial reporting system in order to make recommendations intended to increase the usefulness of financial information to investors, while reducing the complexity of the financial reporting system to investors, preparers, and auditors.

More specifically, our charter identifies the following areas of inquiry:

- The current approach to setting financial accounting and reporting standards, including: (1) the principles-based versus rules-based standards, (2) the inclusion within standards of exceptions, bright lines, and safe harbors, and (3) the process for providing timely guidance on implementation issues and emerging issues
- The current process of regulating compliance with accounting and reporting standards
- The current system for delivering financial information to investors and accessing that information
- Other environmental factors that drive avoidable complexity, including the possibility of being "second-guessed," the structuring of transactions to achieve an accounting

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<sup>20</sup> See, SEC, *SEC Establishes Advisory Committee to Make U.S. Financial Reporting System More User-Friendly for Investors*, SEC Press Release No. 2007-123 (June 27, 2007) (included as appendix A).

<sup>21</sup> See, SEC, *Advisory Committee on Improvements to Financial Reporting*, SEC Release No. 33-8817 (July 2, 2007) [72 FR 36077] (included as appendix B).

<sup>22</sup> See, Committee charter (included as appendix C).

<sup>23</sup> See, SEC, *SEC Chairman Cox Announces Members of Advisory Committee on Improvements to Financial Reporting*, SEC Press Release No. 2007-154 (July 31, 2007) (included as appendix D). This press release describes the diverse backgrounds of the Committee members.

<sup>24</sup> See, Committee by-laws (included as appendix E).

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result, and whether there is a hesitance by professionals to exercise professional judgment in the absence of detailed rules

- Whether there are current accounting and reporting standards that do not result in useful information to investors, or impose costs that outweigh the resulting benefits
- Whether the growing use of international accounting standards has an impact on the relevant issues relating to the complexity of U.S. accounting and reporting standards and the usefulness of the U.S. financial reporting system.

At the start of our work, the Committee agreed to issue focused recommendations, addressing acknowledged problem areas, that we believed could be adopted in a reasonable time period by the SEC, the Financial Accounting Standards Board (FASB or Board), or the Public Company Accounting Oversight Board (PCAOB). We agreed to avoid recommendations requiring legislative action or attempting to address all perceived shortcomings in the financial reporting system.

### **III. Our Guiding Principles**

We believe that financial reporting should provide information that aids investors in making investment, credit, and similar resource allocation decisions.<sup>25</sup> Of paramount importance are investors, defined as all providers of capital, including current and potential providers of equity capital and creditors.<sup>26</sup>

Some argue that, over time, financial reporting has become a burdensome compliance exercise with decreasing relevance to investors. This effect can be attributed, in part, to: (1) the evolution of new business strategies and financing techniques that stretch the limits of what the traditional reporting framework can effectively convey, and (2) an overly litigious culture that, arguably, results in financial reporting designed as much to protect against liability as to inform investors. As a result, we believe the disconnect between current financial reporting and the information necessary to make sound investment decisions has become more pronounced.

A key factor often cited as driving this disconnect is complexity, which has rarely been defined in the context of financial reporting. We developed and applied the following definition of complexity in this context to guide our deliberations:

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<sup>25</sup> Adapted from the FASB and IASB exposure draft, *Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information* (May 29, 2008), which states, “The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers. Information that is decision useful to capital providers may also be useful to other users of financial reporting who are not capital providers.”

<sup>26</sup> We recognize there are other important users of financial statements, such as credit rating agencies.

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## Definition of Complexity

The state of being difficult to understand and apply. Complexity in financial reporting refers primarily to the difficulty for:

1. Investors to understand the economic substance of a transaction or event and the overall financial position and results of a company
2. Preparers to properly apply generally accepted accounting principles in the U.S. (U.S. GAAP) and communicate the economic substance of a transaction or event and the overall financial position and results of a company
3. Other constituents to audit, analyze, and regulate a company's financial reporting.

Complexity can impede effective communication through financial reporting between a company and its stakeholders. It also creates inefficiencies in the marketplace (e.g., increased investor, preparer, audit, and regulatory costs) and suboptimal allocation of capital.

## Causes of Complexity

The causes of complexity are many and varied. We have identified the following significant causes of complexity:

1. Complex activities – The increasingly sophisticated nature of business transactions can be difficult to understand, particularly with respect to the growing scale and scope of companies with operations that cross international boundaries and financial reporting regimes.
2. Incomparability and inconsistency – Incomparable reporting of activities within and across entities arises because of factors such as the mixed attribute model, bright lines, and exceptions to general principles. Some accounting guidance permits the structuring of transactions in order to achieve particular financial reporting results. Further, to the extent new pronouncements are adopted prospectively, past and present periods of operating results are not comparable. This is compounded by the rapid pace at which new accounting pronouncements are being adopted, which hinders the ability of all constituents to understand and apply new guidance in relatively short timeframes.
3. Nature of financial reporting standards – Standards can be difficult to understand and apply for several reasons, including:
  - The existence of opposing points of view that were taken into account when developing standards – most importantly, the attempts by public companies to smooth amounts that vary from period to period, versus the requests from those who want such amounts recorded as incurred
  - The challenge of describing accounting principles in simple terms (i.e., plain English) for highly sophisticated transactions
  - The presence of detailed guidance for numerous specific fact patterns

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- The impact of multiple bodies setting standards
  - The development of such standards on the basis of an incomplete and inconsistent conceptual framework.
4. Volume – The vast number of formal and informal accounting standards, regulations, and interpretations, including redundant requirements, make finding and evaluating the appropriate standards and interpretations challenging for particular fact patterns.
  5. Audit and regulatory systems that complicate the use of professional judgment – The risk of litigation and the fear of being “second-guessed” result in: (1) a greater demand for detailed rules on how to apply accounting standards to an ever increasing set of specific situations, (2) unnecessary restatements that are not meaningful to investors, and (3) legalistic disclosures that are difficult to understand.
  6. Educational shortcomings – Undergraduate and graduate education in accounting has traditionally emphasized the mechanics of double-entry bookkeeping, which favors the use of detailed rules rather than the full understanding of relevant principles. The same approach is evident in the certified public accountant (CPA) exam, as well as continuing professional education requirements.
  7. Information delivery – The need for information varies by investor type and is often driven by legal risk, rather than investor needs. In addition, the lack of a holistic approach to disclosures, the amount and timing of information, and the method by which it is transmitted, may result in complex and hard-to-navigate disclosures that cause investors to sort through material that they may not find relevant in order to identify pieces that are. These factors make it difficult to distinguish the sustaining elements of an entity from non-operating or other influences.

We observe that two types of substantive complexity exist: (1) unavoidable complexity, which is a function of the underlying transaction or item being accounted for, such as the first cause of complexity noted above, and (2) avoidable complexity, which is introduced from other sources. Our focus is on avoidable complexity, with an emphasis on improvements that are feasible in the near-term.

#### **IV. Our Scope**

##### **IV.A. Public Company Focus**

We have limited our deliberations to matters involving SEC registrants. While financial reporting matters and, more specifically, U.S. GAAP, also apply to private companies and non-profit entities, our focus is consistent with our role as an advisory committee to the SEC.

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## **IV.B. International Matters**

The global financial reporting environment has changed dramatically over the past six years. Specifically, in 2002, the European Union adopted a regulation requiring its listed companies to report under international financial reporting standards (IFRS) by 2005. Also in 2002, the FASB and the International Accounting Standards Board (IASB) agreed to work together to converge U.S. GAAP and IFRS over time.<sup>27</sup> In 2007, the SEC amended its rules to eliminate the requirement for a U.S. GAAP reconciliation for foreign private issuers reporting under IFRS as issued by the IASB,<sup>28</sup> and issued a concept release<sup>29</sup> to explore a more far-reaching prospect – the possibility of giving domestic issuers the alternative to report using IFRS.

These events have heightened the debates regarding the future of the financial reporting system in the U.S. These debates involve both the end state (i.e., whether to support a single set of high-quality global accounting standards) and the best way to accomplish that end state in the U.S. (i.e., the transition).<sup>30</sup> We broadly support the continued move to a single set of high-quality global accounting standards, coupled with enhanced international coordination to foster their consistent interpretation and to avoid jurisdictional variants. Further, we encourage the development of a roadmap to identify issues and milestones to transition to this end state in the U.S., with sufficient time to minimize disruptions, resource constraints, and the complexity arising from such a significant change.<sup>31</sup>

Notwithstanding the above, throughout the remainder of this report, we have focused our scope on the U.S. financial reporting environment for two reasons. First, as the Commission has already received extensive public input regarding the expanded use of IFRS in the U.S., our deliberations would likely add little new information to the debate. Second, we believe that full transition may take years to achieve, so that U.S. GAAP will

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<sup>27</sup> FASB and IASB memorandum of understanding, *The Norwalk Agreement* (September 18, 2002).

<sup>28</sup> SEC, *Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP*, SEC Release No. 33-8879 (December 21, 2007).

<sup>29</sup> SEC, *Concept Release On Allowing U.S. Issuers To Prepare Financial Statements In Accordance with International Financial Reporting Standards*, SEC Release No. 33-8831 (August 7, 2007).

<sup>30</sup> Some constituents understand “transition” or “convergence” to mean that U.S. GAAP and IFRS (as issued by the IASB) will eventually be harmonized, at which point no substantive differences will exist between the two bodies of accounting literature. Others understand it to mean a discrete transition from U.S. GAAP to IFRS at a specified date without respect to whether the two bodies of literature are substantially harmonized at the date of transition. We use these terms broadly and interchangeably to refer to the movement from the current financial reporting system in the U.S. to its ultimate end state, without endorsement of the specific approach to do so.

<sup>31</sup> See, Chairman Christopher Cox, *Making Disclosure More Useful for Public Company Directors*, Keynote Address to the Stanford Law School Directors’ College, Palo Alto, CA, (June 23, 2008).

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continue to be utilized by many U.S. public companies for a number of years. Therefore, we believe that it is quite fruitful to recommend enhancements to the current financial reporting system in the U.S.

Despite this focus on U.S. GAAP, we believe that the principles underlying our recommendations are relevant, regardless of the end state of convergence. For example, we believe our recommendations to improve the standards-setting process would be relevant to any accounting standards-setter. Furthermore, to the extent feasible, we point out how our recommendations can be coordinated with the work of the IASB and the development of IFRS, with the objective of promoting convergence.

## **V. Our Approach**

### **V.A. Subcommittee Structure**

To facilitate the development of these recommendations, at our first open meeting on August 2, 2007,<sup>32</sup> we adopted a subcommittee structure proposed by the Committee Chairman in a discussion paper that provided a working outline and potential considerations for the Committee.<sup>33</sup> Our subcommittees were as follows:

1. Substantive Complexity
2. Standards-Setting Process
3. Audit Process and Compliance
4. Delivering Financial Information

The July 31, 2007 discussion paper initially contemplated the establishment of an International Coordination subcommittee in 2008. However, for the reasons mentioned above, this additional subcommittee was not established.

### **V.B. Committee and Subcommittee Meetings**

Each of these four subcommittees researched, deliberated, sought views from various constituents, and considered comment letters received, in order to prepare proposals for consideration by the full Committee. At our open meeting on November 2, 2007, in Washington D.C., each subcommittee provided the full Committee with an update of its deliberations to date, as well as any preliminary hypotheses regarding matters it intended,

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<sup>32</sup> This and all of our subsequent full Committee meetings were open to the public and conducted in accordance with the requirements of the Federal Advisory Committee Act (5 USC-App. 2 §1). All meetings of the full Committee were also webcast or audiocast over the internet.

<sup>33</sup> Committee Chairman Robert C. Pozen, *Discussion Paper for Consideration by the SEC Advisory Committee on Improvements to Financial Reporting* (July 31, 2007), available at [http://www.sec.gov/about/offices/oca/acifr/acifr\\_discussion.htm](http://www.sec.gov/about/offices/oca/acifr/acifr_discussion.htm).

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subject to further discussion, to ultimately recommend to the full Committee for consideration in developing its final report of recommendations to the Chairman of the SEC.

Subsequent to the November 11, 2007 open meeting, each subcommittee continued its fact-finding and deliberations to refine its preliminary hypotheses into: (1) developed proposals, (2) conceptual approaches, or (3) future considerations. Developed proposals were proposals that we believed could be implemented by the Commission, its staff, or other bodies, as appropriate. Conceptual approaches represented our initial views at the time, which were based on discussions on a particular subject, but which still required additional vetting before formalization into a developed proposal. Matters for future consideration were areas in which deliberations and research had not yet begun. At the Committee's open meeting on January 11, 2008, in Washington D.C., the full Committee received further updates from each subcommittee since the previous open meeting; further deliberated each of the developed proposals; and adopted all developed proposals, conceptual approaches, and matters for future consideration.<sup>34</sup>

At our open teleconference meeting on February 11, 2008, we reviewed a draft progress report discussing the Committee's developed proposals, conceptual approaches, and future considerations. All Committee members present at our February 11, 2008 meeting voted unanimously to issue this progress report to the Chairman of the SEC and to publish the progress report in order to encourage public feedback. This progress report was issued in final form on February 14, 2008 (Progress Report).<sup>35</sup>

Subsequent to the issuance of the Progress Report, each subcommittee continued its refinement of its developed proposals and its work on its conceptual approaches and future considerations, through consideration of further research, deliberations, testimony, and comment letters. In addition, at our open meeting on March 13 and 14, 2008, in San Francisco, and our open meeting on May 2, 2008, in Chicago, we received public testimony from a total of five panels, each consisting of seven witnesses from various constituencies, in the areas of materiality, judgment, eXtensible Business Reporting Language (XBRL), substantive complexity, and the standards-setting process.<sup>36</sup>

These efforts culminated in the preparation of a draft final report, reflecting draft recommendations proposed by each of the subcommittees for consideration by the full

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<sup>34</sup> The Committee's vote to adopt the developed proposals, conceptual approaches, and matters for future consideration was unanimous, except for one dissenting vote from Mr. Peter Wallison regarding the timing of adoption of XBRL-tagged financial statements and the need for auditor assurance on the tagging process. See separate statement regarding this dissenting vote in appendix A of the Progress Report, available at <http://www.sec.gov/rules/other/2008/33-8896.pdf>.

<sup>35</sup> Our Progress Report is available at <http://www.sec.gov/rules/other/2008/33-8896.pdf>.

<sup>36</sup> Refer to appendix F for a list of witnesses on these panels.

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Committee. This draft final report was published on the Commission's website on July 7, 2008. We discussed this draft final report at our open meeting on July 11, 2008, in Washington D.C., and all Committee members present voted unanimously in favor of each draft recommendation.

[At the Committee's open teleconference meeting on July 31, 2008, we reviewed an updated draft final report. All Committee members present voted unanimously to issue to the Chairman of the SEC this final report of the Committee's recommendations to the SEC<sup>37</sup> to improve financial reporting.]

### **V.C. Comment Letters**

In developing this final report, we carefully considered all comment letters received.<sup>38</sup> We made, through the Commission, four formal requests for comments on issues we were considering. Specifically, on August 24, 2007, we published a release in the Federal Register formally seeking public comment on Chairman Pozen's discussion paper dated July 31, 2007.<sup>39</sup> On February 28, 2008, we formally requested comment on our Progress Report.<sup>40</sup> On May 22, 2008, we formally requested comment on each subcommittee's update report dated May 2, 2008.<sup>41</sup> Finally, on July 17, 2008, we formally requested comment on our draft final report dated July 11, 2008.<sup>42</sup> In addition, each of our meetings was announced by formal notice in a Federal Register release, and each such notice included an invitation to submit written statements to be considered in connection with the meeting. We also welcomed feedback at any time from investors, preparers, auditors, and others on the Committee's work, and maintained an open comment box via our dedicated page on the Commission's website.

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<sup>37</sup> In our role as an advisory committee to the SEC, we have addressed most of our recommendations to the SEC, while noting the need for involvement of other bodies, such as the FASB and the PCAOB. We also note that some of our recommendations may require SEC action, while others may be implemented by SEC staff. We have, however, generally adopted a convention of addressing these areas to the SEC for convenience. We leave the determination of whether the proposals require SEC or SEC staff action to the discretion of the SEC and its staff. This report does not necessarily reflect the views or regulatory agenda of the SEC or its staff.

<sup>38</sup> Comments to the Committee are available at <http://www.sec.gov/comments/265-24/265-24.shtml>.

<sup>39</sup> See, *Request for Comments on Discussion Paper for Consideration by the SEC Advisory Committee on Improvements to Financial Reporting*, SEC Release No. 33-8836, (August 24, 2007) [72 FR 48700].

<sup>40</sup> See, *Request for Comments on Progress Report of the SEC Advisory Committee on Improvements to Financial Reporting*, SEC Release No. 33-8896 (February 28, 2008) [73 FR 10898].

<sup>41</sup> See, *Request for Comments on Subcommittee Reports of the SEC Advisory Committee on Improvements to Financial Reporting*, SEC Release No. 33-8918 (May 22, 2008) [73 FR 29808].

<sup>42</sup> See, *Notice of Meeting of SEC Advisory Committee on Improvements to Financial Reporting*, SEC Release No. 33-8942 (July 17, 2008) [73 FR 41138].

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## **VI. Organization of this Report**

This final report is organized by the topics considered by our four subcommittees. Thus, chapter 1 is on substantive complexity, chapter 2 on the standards-setting process, chapter 3 on audit process and compliance, and chapter 4 on delivering financial information.

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## CHAPTER 1: SUBSTANTIVE COMPLEXITY

### I. Introduction

Public companies in the U.S. submit financial statements to the SEC so investors can monitor their financial performance and make decisions about capital allocation. Traditionally, those financial statements are prepared using a common framework referred to as U.S. GAAP. A casual review of audited financial statements might create a perception that amounts reported in a balance sheet or income statement are mechanical and precise, when they, in fact, reflect a great deal of choice, estimation, and judgment.

While, ideally, U.S. GAAP should provide clear and consistent guidance for preparing financial statements, this is not always true. A number of factors undermine this ideal, including the causes of complexity enumerated in the introduction to this report. As a result, certain parts of U.S. GAAP may actually hinder effective comparison of financial performance between companies. For instance, a large company may purchase a smaller company to acquire a newly-developed patent that the smaller company obtained to protect a promising new product. In that scenario, the purchasing company would value the patent and record it as an asset under U.S. GAAP. However, if the smaller company was not purchased, but continued developing the product on its own, it would be prohibited by U.S. GAAP from recording an asset to reflect the patent on its balance sheet.

This example is just one illustration of the avoidable complexity currently embedded in U.S. GAAP. We have identified what we consider to be the four most pressing forms of avoidable substantive complexity that currently exist in financial reporting: (1) the mixed attribute model that blends the use of fair value and historical cost, (2) the lack of a holistic approach to disclosures, (3) certain bright lines, and (4) exceptions to general principles.

The mixed attribute model results in amounts that are a blend of accounting conventions. Some assets and liabilities are measured at historic cost, others at lower of cost or market, and still others at fair value. Some advocate using fair value for the entire balance sheet as a solution to this blending effect. However, this approach would compound existing questions about the relevance and reliability of certain valuation modeling techniques, including considerable subjectivity in the valuation of thinly-traded assets and liabilities.

Disclosure provides important context for the estimates and judgments reflected in the financial statements. It also highlights risks and uncertainties outside of the statements that could impact financial performance in the future. Historically, disclosure standards have developed in a piecemeal manner, resulting in redundancies, confusion, and disorganized presentations in financial reports. These factors make complete and meaningful communication between companies and investors challenging.

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Bright lines can create arbitrary borders along a continuous spectrum of transactions. More problematic, certain reporting standards require drastically different accounting treatments on either side of a bright line that may not be warranted based on the underlying economics. Lease accounting is often cited as an illustration of bright lines. Consider, for example, a lessee's accounting for a piece of machinery. Under current requirements, a very small difference in quantitative tests can lead to totally opposite accounting results – the leased asset is reflected on the lessee's balance sheet, or it is not captured on the balance sheet at all.<sup>43</sup>

Exceptions to general principles can also create complexity because they deviate from established standards that are applicable to most companies. In effect, investors and preparers no longer speak a uniform language to communicate financial information; they must learn new dialects. Other constituents in that communication process are similarly impacted. We have identified four types of these exceptions that contribute to complexity. First, some areas of industry-specific guidance conflict with generalized U.S. GAAP that applies across most industries.<sup>44</sup> Second, alternative accounting policies give preparers options among acceptable practices, such as whether or not to apply hedge accounting,<sup>45</sup> which reduce comparability across companies. Third, scope exceptions<sup>46</sup> represent departures from a principle and require detailed analyses to determine whether they apply. Fourth, competing models create requirements to apply different accounting treatments to similar types of transactions or events, depending on the balance sheet or income statement items involved. This diversity requires all constituents to understand assorted implementation methods, even though they are based on similar fundamental principles.

The remainder of this chapter discusses how these areas contribute to complexity in greater depth and, more importantly, provides recommendations to reduce their effects in a reasonable time period, to the extent feasible.

Lastly, while our deliberations have been conducted primarily in the context of the current U.S. environment, we believe our observations and recommendations will remain relevant if the international financial reporting environment changes. As it relates to IFRS itself, we point out how some problems in U.S. GAAP might be avoided in IFRS as

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<sup>43</sup> See discussion of bright lines in section IV of this chapter below for further details.

<sup>44</sup> See comparison of Statement of Financial Accounting Standard (SFAS) No. 51, *Financial Reporting by Cable Television Companies*, with SEC Staff Accounting Bulletin (SAB) 104, *Revenue Recognition* (as codified in SAB Topic 13), later in this chapter.

<sup>45</sup> Hedge accounting guidance is provided in SFAS No. 133, *Accounting for Derivatives and Hedging Activities*.

<sup>46</sup> Throughout this chapter, the term "scope exceptions" refers to scope exceptions other than industry-specific guidance.

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it matures, whereas we affirm other efforts of the IASB that we believe are headed in the right direction. More broadly, with respect to matters of convergence, we believe the principles underlying our recommendations will benefit financial reporting regardless of the approach ultimately taken in the U.S.

## **II. Mixed Attribute Model**

As previously noted, the mixed attribute model is one in which the carrying amounts of some assets and liabilities are measured at historic cost, others at lower of cost or market, and still others at fair value. Complexity arising from the mixed attribute model is compounded by requirements to record some adjustments in earnings, while others are recorded in equity (i.e., comprehensive income). For example, changes in the fair value of a derivative may be charged directly to equity, while changes in the fair value of a trading security are recognized in net income.

Optimally, the FASB should develop a consistent approach to determine which measurement attribute should apply to different types of business activities (in particular, it should address whether and when fair value should be used).<sup>47</sup> While we are aware that the FASB has a long-term project to develop such an approach, known as the measurement framework, we advocate a number of steps in the near-term to improve the clarity of financial statements for investors.

First, we recommend a judicious approach to expanding the use of fair value in financial reporting until a number of practice issues are better understood and resolved, and the FASB completes its measurement framework. Second, we recommend consideration of a consistent presentation of amounts in the financial statements based on their distinct measurement attributes, grouped by meaningful categories, such as the operating, investing, and financing sections. This will make subtotals of individual line items in the statements more meaningful. Third, we recommend a reconciliation of the statements of income and cash flows by major classes of measurement attributes to help investors analyze earnings. Fourth, we recommend the development of a disclosure framework, which would enable investors to better understand the key risks and uncertainties associated with different measurement attributes (refer to section III of this chapter).

***Recommendation 1.1: Avoidable complexity caused by the mixed attribute model should be reduced in the following respects:***

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<sup>47</sup> See, e.g., comment letter from Fitch Ratings, Inc. (April 2, 2008), which states the measurement framework would be part of a “foundation for improved financial reporting.”

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- **Measurement framework – The SEC should recommend that the FASB be judicious in issuing new standards and interpretations that expand the use of fair value in areas where it is not already required<sup>48</sup> until:**
  - **The FASB completes a measurement framework to systematically assign measurement attributes to different types of business activities**
  - **The SEC, the FASB, and other regulators and standards-setters develop and implement a plan to strengthen the infrastructure that supports fair value reporting.**
- **Financial statement presentation<sup>49</sup> – The SEC should recommend that the FASB consider the merits of:**
  - **Assigning a single measurement attribute within each business activity to the maximum extent feasible, which is consistent across the financial statements<sup>50</sup>**
  - **Aggregating financial statements by meaningful categories of business activities, such as the operating, investing, and financing sections**
  - **Developing a practical means for reconciling the statements of income and cash flows by major classes of measurement attributes.<sup>51</sup>**

### **Background**

Examples of accounting standards that result in mixed attribute measurement include two FASB standards related to financial instruments. SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, permits the fair valuation of certain assets and liabilities. As a result, some assets and liabilities are measured at fair value, while

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<sup>48</sup> For instance, improvements to certain existing, particularly complex standards, such as SFAS No. 133 and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, may be warranted in the near-term. Similarly, this recommendation is not intended to delay the revision of standards that currently employ fair value measurement, such as those relating to pension and lease accounting.

<sup>49</sup> We are aware of the FASB and IASB's joint financial statement presentation project and support its objective of dividing a company's individual financial statements into cohesive components.

<sup>50</sup> To make this approach operational, the FASB might establish a rebuttable presumption in favor of a single measurement attribute within each appropriate section. For example, if business activities were grouped into operating, investing, and financing sections, the Board may determine amortized cost is the presumptive measurement attribute within the operating section of a company's financial statements. Nevertheless, the Board would also have to consider whether fair value is appropriate for financial assets and liabilities employed in those business activities, such as certain derivative contracts used to hedge commodity price risk for materials used in the production process.

<sup>51</sup> Before adopting this reconciliation, we believe the FASB should conduct in-depth field work to fully understand the benefits it provides to users, as well as the added burden it creates for preparers and auditors. This should also help the FASB determine whether the reconciliation should be presented as a new primary financial statement or as a footnote disclosure. An example of this presentation is included later in this section.

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others are measured at amortized cost or some other basis. SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, requires certain investments to be recognized at fair value and others at amortized cost.

Historic cost, amortized cost, and fair value measurements are all subject to reliability concerns. Under historic and amortized cost accounting, the need to determine whether assets are impaired illustrates these concerns, as do decisions about the way certain costs should be allocated across quarterly and annual periods. However, in the absence of quoted prices, the implementation of fair value is particularly troublesome.

**Deleted:** However, reliability issues are perceived to be more prevalent today for fair value estimates, in part, because of questions about whether available models accurately capture the effects of market risks and uncertainties.

In practice, costs associated with the use of (potentially uncertain) fair value estimates can be considerable. Some preparers' knowledge of valuation methodology is limited, often requiring the use of valuation specialists. Auditors often require valuation specialists of their own to support the audit. Some view the need for these valuation specialists as a duplication of efforts, at the expense of the preparer (and ultimately, the investor). In addition, there are recurring concerns about "second-guessing" by auditors, regulators, and courts in light of the many judgments and imprecision involved with some fair value estimates. Regardless of whether such estimates are prepared internally or by valuation specialists, the effort and time required to implement and maintain mark-to-model fair values is significant. For these reasons, preparers and auditors will likely have to incur costs to broaden their proficiency in basic valuation matters,<sup>52</sup> and additional education may be required for the larger financial reporting community to become further accustomed to fair value information.

Nevertheless, some have advocated mandatory and comprehensive use of fair value as a solution to the complexities arising from the mixed attribute model.<sup>53</sup> However, opponents argue that this would only shift the burden of complexity from investors to preparers and auditors, among others. Specifically, certain investors may find fair value reporting for all assets and liabilities simpler and more meaningful than the current mixed attribute model. On the other hand, a full fair value approach would diminish the reliability of some reported amounts (while increasing the effort required to prepare them) because they cannot be valued based on observable prices. Further, some estimates depend on model inputs that are also unobservable. These amounts would have to be estimated by preparers and evaluated by auditors, as discussed above. Such estimates are often made even more subjective by the lack of a single set of authoritative generally accepted valuation standards like U.S. GAAP for financial reporting purposes and the use of inputs to valuation models that vary from one company to the next. Likewise, significant variance exists in the quality, skill, and reports of valuation

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<sup>52</sup> For instance, additional training for field auditors may be necessary as they work more frequently with valuation experts.

<sup>53</sup> See, e.g., comment letter from the CFA Institute Centre for Financial Market Integrity (March 31, 2008).

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specialists. Finally, there is no comprehensive mechanism to ensure the ongoing quality, training, and oversight of all valuation specialists for purposes of financial reporting. As a result, some believe a wholesale transition to fair value would reduce the reliability of financial reports to an unacceptable degree.<sup>54</sup>

Therefore, we assume a complete move to fair value is most unlikely.<sup>55</sup> Within this context, the partial use of fair value increases the volume of accounting literature. Said differently, when more than one measurement attribute is used, guidance is required for each one. In addition, some entities may operate under the impression that investors are averse to market-driven volatility. Consequently, entities have demanded exceptions from the use of fair value in financial reporting, resisted its use, and/or entered into transactions that they otherwise would not have undertaken to artificially limit earnings volatility. These actions have resulted in a build up in the volume of accounting literature. More generally, some believe that attempts by companies to smooth amounts that are not smooth in their underlying economics reduce the efficiency and the effectiveness of capital markets.

With respect to investors, in certain instances, information delivery may be made more challenging by fair value. The uncertainty associated with some fair value measurements (i.e., some are merely estimates and, in many instances, lack precision), including the quality of unrealized gains and losses in earnings that arise from changes in fair value, may not be apparent. Some question whether the use of fair value may lead to counterintuitive results. For example, an entity that opts to fair value its debt may recognize a gain when its credit rating declines. Others question whether the use of fair value for held-to-maturity investments is meaningful. Finally, preparers may view disclosure of some of the inputs to the assumptions as sensitive and competitively harmful.

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Despite these difficulties, the use of fair value may alleviate some aspects of avoidable complexity. Such information may provide investors with management's perspective, to the extent management makes decisions based on fair value, and it may improve the relevance of information in many cases, as historical cost is not meaningful for certain items.

Fair value may also enhance consistency by reducing confusion related to measurement mismatches. For example, an entity may enter into a derivative instrument to hedge its

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<sup>54</sup> See, e.g., comment letter from the AFL-CIO (February 10, 2008), which states its "longstanding concerns about the adoption of mark-to-market or fair value accounting as the *predominant* conceptual model by the FASB" (emphasis added).

<sup>55</sup> We did not attempt to resolve the ongoing debate about what should be accounted for at fair value versus some other basis. Rather, we have been focused on explaining better to investors the components of the mixed attribute model through examples such as the one included later in this chapter.

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exposure to changes in the fair value of debt caused by changes in interest rates. The derivative instrument is required to be recognized at fair value, but the debt would generally be measured at amortized cost. This results in a measurement mismatch for accounting purposes, despite the offsetting changes that occur from an economic perspective. In addition, fair value might mitigate the need for detailed application guidance explaining which instruments must be recorded at fair value and help prevent some transaction structuring. Specifically, if fair value was consistently required for all similar activities, entities would not be able to structure a transaction to achieve a desired measurement attribute.

Fair value also eliminates issues surrounding management's intent. For example, entities are required to evaluate whether investments are impaired. Under certain impairment models, entities are required to assess whether they have the intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. Management intent is subjective and, thus, can be difficult to audit. However, the use of fair value would generally make management intent less relevant in assessing the value of an investment.

Finally, we note that concerns about the reliability of fair value estimates may be lessened in the future to the extent firms and regulators strengthen their risk management policies and related infrastructures. As some have noted, reduced trading activity for financial products makes price discovery based on observable market prices difficult.<sup>56</sup> Therefore, as market participants and regulators improve the way they assimilate fair value information to identify and respond to current risk exposures, market liquidity and observable prices should be enhanced. In turn, this may diminish the need to develop estimates of fair value.

### **Discussion**

We acknowledge the view that a complete transition to fair value would alleviate avoidable complexity resulting from the mixed attribute model. However, we also recognize that expanded use of fair value would increase avoidable complexity unless numerous implementation questions are addressed (as discussed above), which extend beyond the scope of our work. Therefore, before expanding the role of fair value in financial reporting, we believe standards-setters and regulators should develop and implement a plan to strengthen the infrastructure that supports its use. Specifically, educational seminars may be necessary to better inform investors about the characteristics of fair value reporting. Likewise, preparers and auditors would benefit from ongoing training in basic valuation matters to reduce dependence on valuation specialists. Finally, the curricula in undergraduate and graduate accounting programs, as

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<sup>56</sup> Financial Stability Forum, *Enhancing Market and Institutional Resilience* (April 7, 2008).

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well as the CPA exam, will need to incorporate concepts of valuation theory and practice. We recognize a plan like this (as well as its execution) will require a coordinated effort among all constituents because each party shares an interest in accurate and reliable financial reports. In other words, standards-setters, preparers, auditors, regulators, and investors all have a role in fair value reporting. As each party gains experience with fair value information, it should be shared and considered by others in the educational effort to facilitate system-wide improvement.

At present, we believe fair value should not be the only measurement attribute in U.S. GAAP. We advise a judicious approach to expanding the use of fair value until a systematic measurement framework is developed. In this regard, we also believe that phase two of the FASB's fair value option project, which may permit a choice to use fair value measurement for certain nonfinancial assets and liabilities, should not be finalized before a measurement framework is completed.

At that point, the FASB should determine measurement attributes based on considerations such as business activity, the relevance and reliability of fair value inputs, and other considerations vetted during the measurement phase of its conceptual framework project. While we prefer an activity-based approach to assigning measurement attributes, we are sympathetic to an approach based on the type of asset or liability in question, such as financial instruments vs. non-financial instruments.<sup>57</sup> This is a natural tension that the FASB should address as part of the measurement framework. For example, in one scenario, the FASB may determine amortized cost is the presumptive measurement attribute within the operating section of a company's financial statements. Nevertheless, the FASB would also have to consider whether fair value is appropriate for financial assets and liabilities employed in those business activities such as certain derivative contracts used to hedge commodity price risk for materials used in the production process.

Most importantly, we believe improved financial statement presentation will provide better transparency for users. We believe the grouping of individual business activities (and related measurement attributes) in meaningful categories would alleviate some of the concerns about fair value in particular. It would also reduce confusion caused by the commingling of all measurement attributes, as well as facilitate earnings analyses based on the natural elements of most profit-driven entities. For instance, if business activities were grouped into operating, investing, and financing sections, operating income could be compared to investing or financing results. Under this approach, companies should present earnings-per-share computations of the net activity in each section.

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<sup>57</sup> See, e.g., comment letter from PricewaterhouseCoopers LLP (March 31, 2008).

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Further, a reconciliation of the consolidated statements of income and cash flows would disaggregate changes in assets and liabilities based on cash, accruals, and changes in fair value, among others. This reconciliation should be more useful to investors, particularly because it would delineate the nature of changes in income (e.g., fair value volatility, changes in estimate) and allow investors to assess the degree to which management controls each one. A visual example of this reconciliation might include the following:<sup>58</sup>

Reconciliation of the Statements of Income and Cash Flows							
	A Cash Flow Statement	B Cash flows Not Affecting Income	C D E Non-cash items affecting income			F Income Statement (A+B+C+D+E)	
			Accounting Accruals Other Than Remeasur- ements	Recurring Fair Value Changes	Remeasure- ments Other Than Recurring Fair Value Changes		
<b>Operating</b>							
Cash received from sales	2,700,000		75,000			2,775,000	Sales
	0			(1,000,000)		(1,000,000)	Loss on trading securities
	0		(9,000)			(9,000)	Depreciation expense
	0				(15,000)	(15,000)	Impairment expense
<b>Investing</b>							
Capital expenditures	(500,000)	500,000				0	
<b>Financing</b>							
Interest paid	(125,000)		(100,000)			(225,000)	Interest expense
	•					•	
	•					•	
Net Cash Flows	<u>XXX</u>					<u>YYY</u>	Net Income

We believe the relationship of rows and columns in this schedule will help investors assess different elements of financial performance. Said differently, the cash and non-cash components of earnings are presented more clearly under this presentation ( $F = A+B+C+D+E$ ) than they are today. The following comments explain the items in the illustration above:

- Column A – Cash received (\$2.7 million) by the company represents the majority of sales recorded in the income statement this period.

<sup>58</sup> We have adapted and modified this table from a similar schedule in the FASB's financial statement presentation project. As indicated in its description, we believe this reconciliation should be prepared at the consolidated level of the reporting entity; it should not be extended to more granular levels, such as an enterprise's operating segments or components. Our illustration of the concepts in the reconciliation does not depict all of the line items that would constitute net income and net cash flows in a complete presentation.

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- Column B – Cash spent to purchase equipment (i.e., \$500,000 of capital expenditures) is recorded as an asset under U.S. GAAP; it is not treated as an immediate expense, and therefore does not affect current income.
- Column C – Accounting accruals reflect routine bookkeeping entries. For instance, sales made on credit (\$75,000) near the end of the period represent revenue in the income statement, even though they will not be collected until a later date. Depreciation expense (\$9,000) is recorded to allocate part of a previously-acquired asset's original cost to the current period. Lastly, the company reduced earnings by 100% of the interest expense it incurred under a lending arrangement this period (\$225,000). Note it only paid a portion of its obligation in cash (\$125,000), leaving the remainder to be paid at a later date.
- Column D – Recurring fair value changes describe items measured at fair value every period (quarterly and annually). In this case, the company recorded a loss (\$1 million) on its actively-traded investment securities due to a market downturn. U.S. GAAP requires adjusting these securities to fair value each period even if they are not sold.
- Column E – Remeasurements other than recurring fair value changes identify adjustments recorded only after a triggering event happens or when management decides that a decrease in value is other-than-temporary. For example, due to unforeseen events, the company recorded a goodwill impairment charge (\$15,000).

Recognizing companies will use different titles for income statement line items, we believe the predominant value of this schedule is the columnar depiction of measurement attributes and the context it provides for earnings analysis. For example, investors should be better equipped to form opinions about a company's earnings quality and the predictability of its future cash flows because they are generally unable to prepare similar reconciliations based on today's financial statements. While this revised presentation does not resolve all of the challenges posed by the mixed attribute model, it represents an improvement over the current approach for investors to understand a company's financial condition and operating results.

The mixed attribute model also exists under IFRS. As such, we believe the concepts in this recommendation apply equally to IFRS, particularly as the IASB works with the FASB on the joint financial statement presentation project.

### **III. Disclosure Framework**

Disclosure provides important context for the estimates and judgments reflected in the financial statements. It also highlights risks and uncertainties outside of the statements that could impact financial performance in the future.

We believe any recommendations regarding new disclosure guidance will be most effective and informative for investors if the FASB and SEC update or, as necessary,

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rescind outdated or duplicative disclosure requirements. Equally important, the presentation of disclosures in SEC filings could be restructured to make them more meaningful. Our recommendation advocates a joint process between these two institutions to achieve these goals.

***Recommendation 1.2: The SEC and the FASB should work together to develop a disclosure framework to:***

- *Integrate existing SEC and FASB disclosure requirements into a cohesive whole to ensure meaningful communication and logical presentation of disclosures, based on consistent objectives and principles. This would eliminate redundancies and provide a single source of disclosure guidance across all financial reporting standards.*
- *Require disclosure of the principal assumptions, estimates, and sensitivity analyses that may impact a company's business, as well as a qualitative discussion of the key risks and uncertainties that could significantly change these amounts over time. This would encompass transactions recognized and measured in the financial statements, as well as events and uncertainties that are not recorded.*

***Recommendation 1.3: The SEC and FASB should also establish a process of coordination for the Commission and the FASB to regularly assess the continued relevance of disclosure guidance in both bodies of literature, particularly as new FASB standards are issued. Existing guidance should be updated or removed, as appropriate.***<sup>59</sup>

### **Background**

Historically, disclosure standards have developed in a piecemeal manner (i.e., standard-by-standard).<sup>60</sup> The lack of an underlying framework has contributed to: (1) repetitive disclosures that may disproportionately emphasize certain risks, (2) excessively detailed disclosures that may confuse rather than inform, and (3) disorganized presentations in financial reports. These factors make complete and meaningful communication of all material information challenging.

As noted above, disclosure provides important context for the estimates and judgments reflected in the financial statements. However, we acknowledge the perception that amounts recognized in financial statements are generally subject to more refined calculations by preparers and higher degrees of scrutiny by investors compared to mere

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<sup>59</sup> We consider coordination between the SEC and the FASB in chapter 2. See also recommendation 2.3 regarding the periodic assessment of existing accounting and related disclosure standards.

<sup>60</sup> See, e.g., comment letter from the Ohio Society of CPAs (March 31, 2008).

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disclosure. As a result, the effectiveness of disclosure standards – whether existing or new – will be governed by the degree to which constituents view them as another compliance exercise rather than an avenue for meaningful dialogue.

In order for a disclosure framework to facilitate such a dialogue between preparers and investors over the long-run, it should establish broad objectives, the specific application of which will vary. For example, in one case, a broad objective to disclose key sensitivities may result in a company disclosing alternative useful lives for the depreciation of its fixed assets. In another situation, a company might disclose different estimates of volatility in the valuation of certain option contracts. However, neither disclosure would be specified in the framework itself. Rather, a framework would identify the more fundamental principle of disclosing sensitivities. Otherwise, disclosure standards will degenerate into myriad rules because standards-setters cannot envision all of the specific future disclosure requirements that would be necessary in different settings.

For example, in the wake of the recent “liquidity crisis,” there has been significant focus on disclosures related to off-balance-sheet entities. Of particular interest is disclosure of structured investment vehicles (SIVs).<sup>61</sup> Recently, certain sponsoring banks have provided liquidity support to SIVs that were unable to sustain financing in the short-term commercial paper market. In some cases, this led the sponsors to consolidate the SIVs under FASB Interpretation No. (FIN) 46(R), *Consolidation of Variable Interest Entities*, which added billions of dollars of assets and liabilities to the sponsors’ balance sheets. Consequently, some constituents have criticized existing disclosure practices and called for standards-setters to require additional “early-warning” disclosure about off-balance-sheet activity (e.g., types of assets held by the SIVs, circumstances that may result in consolidation or loss, and methodologies used to determine fair value and related write-downs).<sup>62</sup> Others counter that: (1) major SIV sponsors already disclosed the magnitude of their investments in off-balance sheet entities prior to the liquidity crisis and (2) further detail would have been uninformative and potentially confusing to investors because it

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<sup>61</sup> From a review of SEC filed documents, we have identified seven SEC filers that sponsored SIVs around the time of the liquidity crisis. Prior to the crisis, most of these filers did not provide quantified disclosure of the unconsolidated SIVs’ assets and liabilities (in some cases, SIV assets and liabilities were aggregated with the assets and liabilities of other off-balance-sheet arrangements—collectively, “VIEs”). Subsequent to the crisis, we note that some sponsors have expanded their disclosures to include additional quantitative information, as well as qualitative disclosures such as the nature of SIV assets, descriptions of SIV investment and operating strategies, risks related to the current environment, and sponsors’ obligations to the SIVs.

<sup>62</sup> FIN 46(R) requires the disclosure of involvement with certain off-balance-sheet entities, including the nature, purpose, size, and activities of the off-balance-sheet vehicle, as well as the reporting enterprise’s maximum exposure to loss in such arrangements. While some observers believe these requirements may have been insufficient, others counter that preparers could have applied them more diligently and that additional investor scrutiny may have been warranted.

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would have amounted to “disclosure overload.” For instance, at the time the decision not to consolidate was reached, some sponsors may have concluded it was quite unlikely that events which might lead to consolidation would actually occur, and that discussion of these scenarios was unnecessary. These two opposing points of view highlight the tension between a detailed, prescriptive approach to disclosure guidance compared to a more principled style. In any event, we agree with observers such as the Financial Stability Forum<sup>63</sup> who have encouraged the FASB and the IASB to expedite their efforts in this particular area of the accounting standards to more clearly portray the risk exposures and potential losses associated with off-balance-sheet entities.<sup>64</sup>

### Discussion

At a minimum, we believe an effective disclosure framework is comprised of three basic elements: (1) a description of the transactions reflected in financial statement captions, (2) a discussion of the relevant accounting provisions, and (3) an analysis of the key supporting judgments, risks, and uncertainties.<sup>65</sup> In the following commentary, we focus largely on the third element.

The elements of the framework noted here are not necessarily new. For instance, the SEC’s *Cautionary Advice Regarding Disclosure about Critical Accounting Policies* encourages disclosure of sensitivity analyses similar to what we describe below. The incremental value of our recommendation is its intent to rationalize the current patchwork state of disclosure standards in financial reports. By way of example, a basic description of the sale of a company’s goods and services is usually provided in the first or second footnote to the audited financial statements, together with an identification of the relevant U.S. GAAP literature. An analysis of recent sales activity and known trends is typically presented in management’s discussion and analysis (MD&A) – and depending on the preparer<sup>66</sup> – with a quantification of key sensitivities in the application of U.S. GAAP. Descriptions of pending lawsuits, competitive threats and other environmental factors relevant to future sales may be sprinkled across a company’s disclosure of risk factors

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<sup>63</sup> The Financial Stability Forum’s recommendation on off-balance-sheet entities is contained in its report, *Enhancing Market and Institutional Resilience* (April 7, 2008).

<sup>64</sup> Beyond disclosure, we provide suggestions for how the FASB might consider improving the requirements related to consolidation, accounting in section IV (bright lines) of this chapter.

<sup>65</sup> We acknowledge the work of the FASB’s Investors Technical Advisory Committee (ITAC) on the topic of a disclosure framework. We also agree with the need to move towards a more principles-based approach for future disclosure standards and have adapted certain elements of ITAC’s thinking in this discussion. Further, much of what we recommend is consistent with the disclosure framework proposed in the SEC staff’s *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (June 2005).

<sup>66</sup> We note the SEC’s guidance on critical accounting policies was not adopted as a final rule, resulting in mixed practice in the disclosure of sensitivities.

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and legal contingencies in different parts of an SEC filing. To the extent this information is organized more logically in a single location – eliminating redundancies where possible – we believe our framework will enhance an investor’s understanding of the business.

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We recognize our disclosure recommendation incorporates factual information that, historically, is presented in audited footnotes, as well as analytical and forward-looking discussions that are typically part of MD&A narratives in SEC filings. We are also aware there are important considerations regarding audit assurance, legal safe harbors, and other liability issues when determining the placement of disclosures in an SEC filing (e.g., footnotes or MD&A). Therefore, an optimally-designed disclosure framework should be developed by the FASB under close coordination with the SEC so that these factors are considered, and so that the Commission amends its guidance where appropriate. For instance, Regulations S-K and S-X may need to be amended, and the impact of XBRL will need to be considered. Further, the way registrants present information could be restructured, as outlined above in the example of a company’s selling effort.

With respect to amounts recorded in the financial statements, a disclosure framework should more effectively signal to investors the level of imprecision associated with significant estimates and assumptions,<sup>67</sup> particularly some fair value measurements. This can be achieved by disclosing the principal assumptions, estimates, and sensitivity analyses that impact a company’s business, as well as a qualitative discussion of the key risks and uncertainties that could significantly change these amounts over time. For example, we note that in certain cases, there is no “right” number in a probability distribution of figures that represents fair value more accurately than others. While SFAS No. 157, *Fair Value Measurements*, established disclosure requirements that provide insight into Level 2 and 3 fair value estimates,<sup>68</sup> it may not be sufficient in all cases. Many investors might find information related to a valuation model helpful. This might encompass key risks associated with certain assumptions<sup>69</sup> and related sensitivity analyses, including a range of possible outcomes predicted by the model and a discussion of the reliability of the model itself.

Outside of amounts recorded in the financial statements, disclosure of environmental factors may be more meaningful than attempting to “force” a wide range of probabilities into a single point estimate on the balance sheet or income statement. This would encompass events and uncertainties such as relevant market conditions and off-balance-

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<sup>67</sup> See, e.g., comment letter from the Center for Audit Quality (March 31, 2008).

<sup>68</sup> SFAS No. 157 established a three level fair value hierarchy. It assigns highest priority to quoted prices in active markets (Level 1) and the lowest priority to unobservable inputs that rely heavily on assumptions (Level 3).

<sup>69</sup> For example, if a valuation model relies on historical assumptions for a period of time that excludes economic downturns, that fact and its implications may need to be disclosed.

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sheet activity. Some constituents argue that recording an estimate to reflect these events, instead of disclosing them, may actually provide a misleading sense of precision. Alternatively, they suggest companies could communicate to investors more effectively by disclosing the factors that might trigger financial statement recognition, the magnitude of possible and/or probable transactions, and management's plans in those scenarios.

We acknowledge disclosure guidance generally establishes a "floor" for communication between companies and investors, rather than a "ceiling."<sup>70</sup> Our recommendation offers a cohesive structure for the narrative that supports and explains the financial statements, but we believe preparers should take the initiative in tailoring financial reports for investors so they can make fully-informed decisions about capital allocation.

Moving forward, the SEC or its staff should update, and as needed, remove portions of public company disclosure guidance that are impacted by new FASB standards. We are aware of efforts in the past conducted to identify overlaps of this type. In particular, the FASB report on "GAAP-SEC Disclosure Requirements," which was a part of a larger Business Reporting Research Project, identified a number of duplicative requirements between FASB standards and SEC guidance. Indeed, several areas of overlap identified in that 2001 report were never addressed.<sup>71</sup> Unless the SEC or its staff establishes a monitoring process to update disclosure requirements, similar problems will persist and may confuse investors. Further, if recommendation 1.7 to minimize industry-specific

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<sup>70</sup> We note companies are not precluded from providing disclosure of the type proposed here. Indeed, certain existing guidance is largely consistent with our views, such as Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*; Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*; Item 303(a) of Regulation S-K related to MD&A; and SEC, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, SEC Release No. 33-8040 (December 12, 2001).

<sup>71</sup> These include:

- Income taxes - Regulation S-X, Rule 4-08(h)(1) is redundant with paragraph 45 of SFAS No. 109, *Accounting for Income Taxes*, because both require disclosure of the significant components of income tax expense for the period.
- Major customers - The disclosure about major customers required by Regulation S-K is largely redundant with the disclosure required by paragraph 39 of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*.
- Contingencies - The disclosures required by Item 103 of Regulation S-K are largely redundant with the basic disclosure requirements of: (1) SFAS No. 5, *Accounting for Contingencies*, (e.g., the requirement to disclose any material pending legal proceedings) and (2) as they pertain to environmental liabilities, with SoP 96-1, *Environmental Remediation Liabilities*.

Beyond these particular redundancies (which are only illustrative), we deemed a separate project to comprehensively identify and resolve overlaps between U.S. GAAP and SEC requirements outside the scope of our work, particularly in light of the significant number of standards that have been issued or amended since the FASB's report was first issued in 2001.

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accounting guidance is adopted, the SEC or its staff may need to consider revising its Industry Guides in Items 801 and 802 of Regulation S-K.<sup>72</sup>

From an international perspective, we note IAS 1, *Presentation of Financial Statements*, includes some of the elements that we would expect of a disclosure framework, such as a principle for: (1) what the notes to the financial statements should disclose, (2) footnote structure, (3) disclosures of judgments, and (4) disclosures of key sources of estimation or uncertainty, including sensitivity analyses. Nonetheless, we believe that our recommendation in this area would also result in improvements to IFRS, particularly as financial statements prepared on that basis become more common in SEC filings.

#### **IV. Bright Lines**

At a high level, bright lines refer to arbitrary thresholds in U.S. GAAP, which, in many cases, can lead to questionable accounting results. However, some clearly marked boundaries are, in fact, useful to reduce confusion and promote comparability.

Generally speaking, we believe a number of bright lines currently used in recognition guidance could be replaced with other approaches or, at a minimum, improved upon. Recognition establishes if and when to record an asset, liability, revenue, or expense in the primary financial statements (e.g., whether an obligation for future lease payments and the related asset would be recorded on the balance sheet). In contrast, other bright lines exist in measurement and presentation guidance that we believe are helpful. Measurement involves choosing the right attribute or characteristic as a basis for quantifying a recognized item. For instance, the original cost and current fair value of a building are likely different numbers. One of them must be selected, depending on the reason for presenting this figure in the financial statements or footnotes. Presentation relates to how an item is portrayed on the face of the financial statements, such as whether an asset is classified as current or long term.

Our comments in this area are designed to assist standards-setters and regulators to better capture the substance of transactions in financial reporting standards, recognizing a limited number of bright lines support this goal.

***Recommendation 1.4: Recognition guidance in U.S. GAAP should be based on a presumption that bright lines should not exist. As such, the SEC should recommend that the recognition guidance in new projects undertaken jointly or***

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<sup>72</sup> We note the SEC's recent announcement regarding its "21<sup>st</sup> Century Disclosure Initiative," which involves an internal study to improve the usefulness and timeliness of disclosures and the formation of a follow-on advisory committee. We understand that one area of focus will be needless redundancy in SEC forms and reporting requirements. We believe these efforts will complement our recommendation to reduce redundancies between FASB and SEC disclosure requirements.

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*separately by the FASB avoid the use of bright lines, in favor of proportionate recognition.<sup>73</sup> Where proportionate recognition is not feasible or applicable, the FASB should provide qualitative factors in its recognition guidance. Finally, enhanced disclosure should be used as a supplement or alternative to the two approaches above.*

*Any new projects should also include the elimination of existing bright lines in the recognition guidance of relevant areas to the extent feasible as a specific objective of those projects, in favor of the two approaches above.*

***Recommendation 1.5:*** *Constituents should be better trained to consider the economic substance and business purpose of transactions in determining the appropriate accounting, rather than relying on mechanical compliance with rules. As such, the SEC should undertake efforts [to](#), and also recommend that the FASB, academics, and professional organizations, better educate students, investors, preparers, auditors, and regulators in this respect.*

### **Background**

As they relate to financial statement recognition, bright lines refer to two main areas: quantified thresholds and pass/fail tests (discussed below).<sup>74</sup> They also address how amounts are measured and presented in the financial statements, such as the current value of an investment and whether it is classified as short-term or long-term.

Lease accounting is often cited as an example of bright lines in the form of quantified thresholds. Consider, for example, a lessee's accounting for a piece of machinery. Under current requirements, the lessee will account for the lease in one of two significantly different ways: either (1) reflect an asset and a liability on its balance sheet, as if it owns the leased asset, or (2) reflect nothing on its balance sheet. The accounting conclusion depends mainly on the results of two quantitative tests,<sup>75</sup> where a mere 1% difference in the test results leads to very different accounting.

The other area of bright lines in this section includes pass/fail tests, which are similar to quantitative thresholds because they result in recognition on an all-or-nothing basis.

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<sup>73</sup> We define proportionate recognition to mean accounting for one's rights and obligations as a party to a contract, as discussed later in this section.

<sup>74</sup> Refer to appendix G for additional examples of bright lines.

<sup>75</sup> Specifically, SFAS No. 13, *Accounting for Leases*, requires that leases be classified as capital leases and recognized on the lessee's balance sheet where: (1) the lease term is greater than or equal to 75% of the estimated economic life of the leased property or (2) the present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90% of the fair value of the leased property, among other criteria.

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However, these types of pass/fail tests do not involve quantified thresholds. For example, a software sales contract may require delivery of four elements. Revenue may, in certain circumstances, be recognized as each element is delivered. However, if appropriate evidence does not exist to support the allocation of the sales price to, for example, the fourth element, revenue cannot be recognized until such evidence does exist or *all* four elements are delivered.

These types of bright lines arise for a number of reasons. These include a drive to enhance comparability across companies by making it more convenient for preparers, auditors, and regulators to reduce the amount of effort that would otherwise be required in applying judgment (i.e., debating potential accounting treatments and documenting an analysis to support the final judgment). Bright lines are also created in response to requests for additional guidance on exactly how to apply the underlying principle. These requests often arise from concern on the part of preparers and auditors of using judgment that may be “second-guessed” by inspectors, regulators, and the trial bar. Finally, bright lines reflect efforts to curb “abuse” or to inject a level of “conservatism” by establishing precise rules to avoid problems that have occurred in the past.

Bright lines can also contribute to avoidable complexity by making financial reports less comparable. This is evident in accounting that is not faithful to a transaction’s substance, particularly when application of the all-or-nothing guidance described above is required. Bright lines produce less comparability because two similar transactions may be accounted for differently. For example, as described above, a mere 1% difference in the quantitative tests associated with lease accounting could result in very different accounting consequences. Some bright lines permit structuring opportunities to achieve a specific financial reporting result (e.g., whole industries have been developed to create structures to work around the lease accounting rules). Further, bright lines increase the volume of accounting literature as standards-setters and regulators attempt to curb abusively-structured transactions. The extra literature creates demand for additional expertise to account for certain transactions. All of these factors add to the total cost of accounting and the risk of restatement.

On the other hand, bright lines may, in some cases, alleviate complexity by reducing judgment and limiting aggressive accounting policies. They may also enhance perceived uniformity across companies, provide convenience as discussed above, and limit the application of new accounting guidance to a small group of companies, where no underlying standard exists. In these situations, the issuance of narrowly-scoped guidance may allow for issues to be addressed on a more timely basis. In other words, narrowly-scoped guidance and the bright lines that accompany them may function as a short-term fix on the road to ideal accounting.

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## **Discussion**

We believe bright lines may be justified in some parts of U.S. GAAP, but not in others. Specifically, we believe bright lines should be minimized in recognition guidance, but may serve an important role in the areas of measurement and presentation. We elaborate on these thoughts below.

### ***Recognition***

Within the context of recognition guidance, we believe bright lines should be minimized in favor of proportionate recognition. As a secondary approach, where proportionate recognition is not feasible or applicable, we recommend that U.S. GAAP be based on qualitative factors, supported by presumptions, as necessary. We also believe that disclosure may be used as a supplement or alternative to the approaches above.

We use the term “proportionate recognition” to describe accounting for one’s rights and obligations as a party to a contract. In contrast to the current all-or-nothing recognition approach in U.S. GAAP, we believe that recognition of rights and obligations would be appropriate in areas such as lease accounting – in effect, an entity would fully recognize its *rights to use* an asset, rather than the physical asset itself. In these cases, regardless of whether the lease is considered to be operating or capital (based on today’s dichotomy), all entities would record amounts in the financial statements to the extent of their involvement in the related business activities. For example, consider a lease in which the lessee has the right to use a machine, valued at \$100, for four years. Also assume that the machine has a 10-year useful life. Under proportionate recognition, a lessee would recognize an asset for its right to use the machine (rather than for a proportion of the asset) at approximately \$38<sup>76</sup> on its balance sheet. Under the current accounting literature, the lessee would either recognize the machine at \$38 or recognize nothing on its balance sheet, depending on the results of certain bright line tests. Similarly, this rights-and-obligations approach may also be relevant in the context of revenue recognition, in particular, in comparison to today’s software revenue recognition model.

However, we acknowledge that proportionate recognition is not universally applicable. For example, proportionate recognition is not applicable in situations where the economics of a transaction legitimately represent an all-or-nothing scenario.<sup>77</sup> In

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<sup>76</sup>For purposes of illustration, \$38 represents a company’s net present value calculations. The example is only intended to be illustrative and is not prescriptive. The basis of proportionate recognition may be an asset’s estimated useful life, its future cash flows, or some other approach, depending on the facts and circumstances.

<sup>77</sup> Examples include determining: (1) whether a contract should be accounted for as a single unit of account or whether it should be split into multiple components, and (2) whether a contract that has characteristics of both liabilities and equity should be treated as one instead of the other.

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situations like these, the FASB should consider providing recognition guidance based on qualitative factors, supported by presumptions, to guide the selection of a single appropriate recognition model by preparers. We believe qualitative factors, including presumptions, would promote the application of principles over compliance with rules, while still narrowing the range of interpretation in practice to facilitate comparability across companies. Admittedly, presumptions may result in all-or-nothing accounting, but differ from bright lines because they are not arbitrary or determinative in their own right.

We use the term “presumptions” to describe a method by which an accounting conclusion may be initially favored (i.e., not stringently applied), subject to the consideration of additional factors. This approach is used to some extent today. For instance, the business combination literature contains an example of a presumption coupled with additional considerations.<sup>78</sup> There are situations in which selling shareholders of a target company are hired as employees by the purchaser because the purchaser may wish to retain the sellers’ business expertise. The payments to the selling shareholders may either be treated as: (1) part of the cost of the acquisition, which means the payments are allocated to certain accounts on the purchaser’s balance sheet, such as goodwill, or (2) compensation to the newly-hired employees, which are recorded as an expense in the purchaser’s income statement, reducing net income. Some of these payments may be contingent on the selling shareholders’ continued employment with the purchaser (e.g., the individual must still be employed three years after the acquisition in order to maximize the total sales price). U.S. GAAP provides several factors to consider when deciding whether these payments should be treated as an expense or not, but establishes a presumption that any future payments linked to continued employment should be treated as an expense. However, it is possible this presumption may be overcome depending on the circumstances.

Finally, we note that disclosure is critical to communicating with investors, either by supplementing financial statement recognition (proportionate or otherwise) or by discussing events and uncertainties outside of the financial statements. We believe that in some cases, disclosure may be more informative than recognition, as point estimates recognized in financial statements may provide a misleading sense of precision. We discuss examples of this situation in our consideration of a disclosure framework in section III of this chapter.

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<sup>78</sup> Emerging Issues Task Force (EITF) 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*. We note EITF 95-8 is nullified by a new FASB standard, SFAS No. 141 (revised 2007), *Business Combinations*. SFAS No. 141 (revised 2007) states “A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation...” However, the guidance in EITF 95-8 is still helpful in describing our approach with respect to the use of presumptions coupled with additional considerations in U.S. GAAP.

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We acknowledge that, historically, practitioners have often gravitated to bright lines to resolve debates and achieve consistency.<sup>79</sup> As such, in order for our recommendations related to bright lines to be operational, we recognize the need for a cultural shift towards the acceptance of more judgment. In this regard, we believe the exercise of reasonable judgment discussed in recommendation 3.5 is essential to their success. We further note that, even if the FASB limits its use of bright lines, other parties may continue to create similar non-authoritative guidance, which may proliferate the use of bright lines. In this regard, we believe that recommendation 2.4 regarding the delineation of authoritative interpretive guidance is helpful, particularly its emphasis that non-authoritative literature has no more standing in U.S. GAAP than its name indicates.

In summary, we believe the FASB should establish recognition guidance using the progression outlined above. That is, it should favor proportionate recognition, moving to the use of qualitative factors and presumptions, only when necessary. Enhanced disclosure should supplement both approaches, and there may be some cases where disclosure is the only effective method of reporting information to investors. The accounting treatment for consolidation policy can be used to illustrate this sequence. For example, the FASB might first consider whether those who invest in an off-balance-sheet entity should record their respective rights and obligations, with no single investor consolidating the entire entity. If the FASB rejected that approach, it might explore whether qualitative factors could be used to identify a single investor with a controlling financial interest that should consolidate.<sup>80</sup> In any event, the FASB should require each investor to disclose the nature and magnitude of its involvement with the entity to provide background for the amounts recorded in the financial statements, as outlined in our consideration of a disclosure framework in section III of this chapter.

#### *Measurement and Presentation*

With respect to the measurement of amounts in the financial statements, we believe bright lines may be justified. Specifically, measurement guidance legitimately represents an all-or-nothing approach, as it would be a non sequitur to suggest a single asset should be measured on the basis of fair value and amortized cost at the same time (refer to section II of this chapter for further discussion of the mixed attribute model).

Similarly, the continued use of bright lines may be justified in presentation guidance.<sup>81</sup> For example, only investments with original maturities of three months or less qualify for presentation as cash equivalents on the balance sheet.<sup>82</sup> This avoids each company

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<sup>79</sup> See, e.g., comment letter from BDO Seidman, LLP (March 31, 2008).

<sup>80</sup> We are aware of the FASB's current efforts to revise FIN 46(R), which appear consistent with the use of qualitative factors envisioned here.

<sup>81</sup> See, e.g., testimony from John Stewart (May 2, 2008).

<sup>82</sup> See SFAS No. 95, *Statement of Cash Flows*.

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establishing its own definition of a cash equivalent. Some might have picked, for example, 30 days, others 60, and still others 180 days, creating needless diversity. The number of years to be presented in the financial statements is also effectively a bright line with positive results (two years of balance sheets, three years for the statements of income and cash flows).

We believe financial reports benefit from the enhanced comparability these types of bright lines create. In addition, we note the risk of misrepresentation and structuring opportunities in this context is minimal.

### ***Other Considerations***

From an international perspective, we note IFRS currently has fewer bright lines than U.S. GAAP. We encourage the SEC to affirm the IASB's efforts on this path.

With respect to training and educational efforts, we note the U.S. Treasury Department's Advisory Committee on the Auditing Profession has offered a number of preliminary recommendations on this topic. We support their direction,<sup>83</sup> and encourage the SEC to monitor these developments as the Commission takes steps, in coordination with the FASB, to promote the ongoing education of all financial reporting constituents (see also recommendation 1.1 for educational efforts related to fair value measurements).

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### **V. Exceptions to General Principles**

On balance, we recommend the elimination of exceptions to general principles because we believe similar activities ought to be accounted for similarly. In the context of the remainder of this chapter, we refer to "activities" in a broad sense. For example, we question whether oil and gas exploration activities are sufficiently different from research and development efforts to justify an accounting model which treats costs that would otherwise be expensed as an asset.<sup>84</sup>

Further, we do not express a view on the role of management intent in defining and distinguishing between business activities.<sup>85</sup> For instance, we do not express a view on

<sup>83</sup> We note that others express similar support. See, e.g., comment letter from Fitch Ratings, Inc. (April 2, 2008).

<sup>84</sup> Some believe an inconsistency of this sort exists between the full cost method of accounting for oil and gas producing activities in Regulation S-X, Rule 4-10 and SFAS No. 2, *Accounting for Research and Development Costs*.

<sup>85</sup> Management intent is a present assertion about management's plans for future courses of action, as noted in the FASB's *Special Report: Future Events: A Conceptual Study of Their Significance for Recognition and Measurement* (1994). Due to the varying levels of management intent throughout U.S. GAAP and the merits of the arguments both for and against its use, we have determined that accounting based on management intent is too dependent on facts and circumstances to feasibly address within our timeframe.

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whether investing for the short-term versus the long-term are separate activities (e.g., trading bonds on price differences in the secondary market, as opposed to holding them until maturity).

#### **V.A. Industry-Specific Guidance**

***Recommendation 1.6: U.S. GAAP should be presumptively based on business activities, rather than industries. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB be scoped on the basis of business activities, except in rare circumstances. Any new projects should include the elimination of existing industry-specific guidance—particularly that which conflicts with generalized U.S. GAAP—in relevant areas as a specific objective of those projects, except in rare circumstances.***

***Considering the pace of convergence efforts, the SEC should also recommend that, in conjunction with its current codification project, the FASB add a project to its agenda to eliminate existing industry-specific guidance which conflicts with generalized U.S. GAAP, except in rare circumstances.***

#### **Background**<sup>86</sup>

Industry-specific guidance refers to: (1) exceptions to general accounting standards for certain industries, (2) industry-specific guidance created in the absence of a single underlying standard or principle, and (3) industry practices not specifically addressed or based in U.S. GAAP. Industries covered by this guidance include, but are not limited to the insurance, utilities, oil and gas, mining, cable television, financial, real estate, casino, broadcasting, and film industries.<sup>87</sup>

Industry-specific guidance has developed for a number of reasons. These include multiple standards-setters issuing guidance without consistently coordinating their efforts, a desire to enhance uniformity throughout an industry, and efforts to customize accounting standards for allegedly “special” transactions or investor needs. In some cases, industries have developed their own practices in the absence of applicable authoritative literature.

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<sup>86</sup> This background section focuses largely on authoritative, industry-specific U.S. GAAP, as opposed to various forms of non-authoritative accounting guidance.

<sup>87</sup> Refer to appendix G for additional examples.

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Industry-specific guidance contributes to avoidable complexity by making financial reports less comparable.<sup>88</sup> This is evident across industries, when conflicting accounting models are used for similar or identical transactions. It may also be used as an improper analogy to achieve desired results or to require more conservative accounting treatments (e.g., by auditors).<sup>89</sup> In addition, the use of an industry to define an accounting treatment raises serious questions about which companies are within the scope of specific guidance. This issue is especially pronounced for diversified companies, which may be involved in a number of different industries.

Further, industry-specific guidance unnecessarily increases the volume of accounting literature. This, in turn, adds to the costs of implementing such literature and maintaining it (e.g., monitoring it for interaction with other new and existing standards and expanding the size and scope of technical resources and databases). Industry-specific guidance also increases the cost of training accountants and retaining industry experts, while compounding the complexity that investors experience in understanding the present variety of accounting and disclosure standards. Lastly, it hinders more widespread use of XBRL by increasing the number of data tags that need to be created, maintained, and properly used to deliver financial information.

On the other hand, industry-specific guidance may, in some cases, alleviate complexity by allowing industry reporting to better meet the specific investor needs in that industry and enhancing comparability across entities within an industry. Further, it may depict important differences in the economics of an industry, particularly where application of a generalized principle may not result in accounting that is faithful to a transaction's substance. We also note that historically, some industry-specific guidance has filled a need where U.S. GAAP is otherwise lacking, and simplified or reduced the amount of guidance a preparer in an industry would need to consider (even though it might increase complexity across industries generally). Finally, specialized guidance has been able to

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<sup>88</sup> As noted previously in the SEC staff's *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (July 2003):

The proliferation of specialized industry standards creates two problems that can hinder standard setters' efforts to issue subsequent standards using a more objectives-oriented regime:

- The existence of specialized industry practices may make it more difficult for standard setters to eliminate scope exceptions in subsequent standards (e.g., many standards contain exceptions for insurance arrangements subject to specialized industry accounting)
- The specialized standards may create conflicting GAAP, which makes it more difficult for accounting professionals to determine the appropriate accounting.

<sup>89</sup> For instance, some auditors may use concepts in revenue recognition from the software industry (SoP 97-2, *Software Revenue Recognition*) as a basis for postponing the revenue recognition of companies in other industries without on-point literature. Opponents of this practice argue such revenue deferral is too conservative and does not adequately portray the extent to which a company may have satisfied its product or service obligations in a long-term or multiple-element contract.

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address prevalent industry issues quickly because it was written for a narrower audience than generalized U.S. GAAP.

Industry-specific guidance can be broken into three categories. First, some industry-specific guidance is explanatory in nature and consistent with generalized U.S. GAAP, such as portions of AICPA Accounting and Auditing Guides that assist preparers interpret and apply existing, generalized U.S. GAAP. Second, other industry-specific guidance is inconsistent with generalized U.S. GAAP. For example, SFAS No. 51 (which covers cable television companies) requires that initial hookup revenue (a type of nonrefundable upfront fee) is recorded to the extent of direct selling costs incurred; the remainder is deferred and recorded in income over the estimated average period that subscribers are expected to remain connected to the system. However, generalized guidance indicates this practice is inappropriate unless it is specifically prescribed elsewhere (such as SFAS No. 51).<sup>90</sup> Therefore, similar activities like upfront fees for gym memberships are not afforded equal treatment. Third, still other industry-specific guidance was created in the absence of a general principle that applies across industries. For instance, while there is no comprehensive revenue recognition standard, SoP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, discusses revenue and cost recognition in areas such as the construction industry.

### **Discussion**

We generally believe that industry-specific guidance should be eliminated to reduce avoidable complexity. We acknowledge that the elimination of existing industry-specific guidance may result in more complexity over the short-term, particularly for the industries losing special treatment. Nonetheless, we believe that it is an acceptable cost for a long-term reduction in avoidable complexity.

However, to mitigate the transitional complexity that may arise from the implementation of this recommendation, we emphasize the following points, which are discussed further below:

- The FASB's initial focus should be the elimination of industry-specific guidance that conflicts with generalized U.S. GAAP
- As such, industry-specific guidance should not be eliminated until generalized guidance is available
- Industry-specific guidance may be justified in the short term due to cost-benefit considerations
- The scope of this recommendation relates to authoritative, rather than non-authoritative, guidance.

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<sup>90</sup> SAB Topic 13.

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First, we believe that the FASB's initial focus should be the elimination of industry-specific guidance that conflicts with generalized U.S. GAAP.<sup>91</sup> To that end, the FASB's codification project should facilitate this effort, as it may be used to sort existing industry-specific guidance into one of the three categories identified above (consistent with U.S. GAAP, inconsistent with U.S. GAAP, or there is no comparable U.S. GAAP). But, industry-specific guidance should not be eliminated until generalized guidance is available. This approach will help ensure that industry-specific guidance that fills a void in U.S. GAAP is not prematurely eliminated, leaving preparers with no relevant guidance and possibly resulting in otherwise avoidable diversity. Subsequently, as the FASB develops new generalized guidance in areas like revenue recognition, it should eliminate industry-specific guidance to the maximum extent feasible. Similarly, the SEC should eliminate its industry-specific guidance in related areas, if any.

Second, we believe that industry-specific guidance may be justified in the short-term when cost-benefit considerations indicate that the enhanced information investors would receive under generalized U.S. GAAP is not justified by the direct costs to preparers and the indirect costs to investors to account for activities in that manner. In such cases, the SEC should encourage the FASB to work with the relevant industry participants to identify long-term ways to improve the benefits and mitigate the costs of the general standard. After making these changes, the related industry-specific guidance should be phased out as efficiently as possible. Towards that end, the SEC should encourage the FASB to provide sufficient time to allow companies to adopt generalized U.S. GAAP with minimal transition costs.

Third, the scope of this recommendation relates to authoritative guidance. This recommendation is not intended to (nor can it) curtail or eliminate non-authoritative guidance. We recognize the benefits of and the demand for guidance that identifies and interprets general U.S. GAAP for a specific industry.<sup>92</sup> We are also aware that constituents, such as the AICPA, have historically addressed this demand by issuing industry-specific implementation guidance. Due to this demand, industry-specific guidance will continue to be developed by parties other than the FASB. However, we stress that such guidance should not be considered authoritative. Rather, this recommendation is addressed to the designated standards-setters, such as the FASB in the U.S., as discussed in chapter 2 of this report. If a designated standards-setter issues guidance for activities that are prevalent in particular industries, we believe it should be applicable to all transactions of the type in question, regardless of the industry in which a company operates.

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<sup>91</sup> See, e.g., comment letter from Ernst & Young LLP (March 31, 2008).

<sup>92</sup> See, e.g., comment letter from KPMG LLP (March 31, 2008).

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From an international perspective, we note that IFRS currently contains less industry-specific guidance than U.S. GAAP. For example, there is extensive revenue recognition guidance under U.S. GAAP spread across more than 140 pieces of literature,<sup>93</sup> including specific guidance for software revenue and sales of real estate. Conversely, a single IFRS standard provides general principles and illustrative examples to address virtually all revenue-generating activities, which contains only 57 paragraphs (including the appendix).<sup>94</sup>

Nonetheless, the SEC should encourage the IASB to be mindful of this recommendation as it continues to develop a more comprehensive body of standards. The SEC should also encourage the IASB to limit future industry-specific guidance to activities whose economics are legitimately different from other business activities. Otherwise, we believe specialized accounting for only certain subsets of similar activities will create avoidable complexity.

### **V.B. Alternative Accounting Policies**

***Recommendation 1.7: U.S. GAAP should be based on a presumption that formally promulgated alternative accounting policies should not exist. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB not provide additional optionality, except in rare circumstances. Any new projects should also include the elimination of existing alternative accounting policies in relevant areas as a specific objective of those projects, except in rare circumstances.***

#### **Background**

Alternative accounting policies refer to optionality in U.S. GAAP. The following discussion addresses formally-promulgated options in U.S. GAAP, but does not address choices available to preparers at more of a practice or implementation level.<sup>95</sup> Examples of optionality in U.S. GAAP include:<sup>96</sup>

- The indirect versus the direct method of presenting operating cash flows on the statement of cash flows
- The application of hedge accounting<sup>97</sup>

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<sup>93</sup> See the *FASB Report* (December 24, 2002).

<sup>94</sup> International Accounting Standard 18, *Revenue*.

<sup>95</sup> For example, companies are free to choose from among several depreciation methods – straight-line, double-declining balance, etc.

<sup>96</sup> Refer to appendix G for additional examples.

<sup>97</sup> We have noted complexities arising from the application of hedge accounting, which allows entities to mitigate reported volatility over the life of the hedge relationship. In this regard, we generally feel that instead of assessing hedge effectiveness to determine whether companies qualify for this alternative

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- The option to measure certain financial assets and liabilities at fair value
- The immediate or delayed recognition of gains/losses associated with defined benefit pension and other post-retirement employee benefit plans
- The successful efforts or full cost accounting method followed by oil and gas producers.

Alternative accounting policies arise for a number of reasons. These include circumstances in which the pros and cons of competing policies may be balanced and thus do not result in a single, clearly preferable approach. Other causes encompass political pressure that results in standards-setters providing for a preferred and an alternative accounting method, high administrative costs of the preferred alternative to preparers (e.g., cost-benefit considerations), and a portrayal of differences in management intent.

Alternative accounting policies contribute to avoidable complexity by making financial reports less comparable. This is evident across companies when identical activities are accounted for differently. Such alternatives may permit accounting that is less reflective of economic substance to the extent that they are based on political pressure, and facilitate differences in accounting policies selected by preparers to achieve the most favorable treatment. The unnecessary proliferation of accounting literature to codify these alternatives also adds to avoidable complexity.

On the other hand, alternative accounting policies may alleviate complexity by allowing preparers to determine the best accounting for particular activities based on cost and economic substance, to the extent that more than one accounting policy is conceptually sound. In addition, certain alternative policies may be developed more quickly than a final “perfect” standard to minimize the effect of other unacceptable practices. In other words, they may function as a short-term fix on the road to ideal accounting.

### **Discussion**

We believe alternative accounting policies should be eliminated, except when: (1) multiple accounting alternatives exist that are consistent with the conceptual framework, and none portray economic substance more accurately than others, or (2) an alternative or interim treatment can be developed more quickly than a final “perfect” standard to minimize the effect of other unacceptable practices.

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accounting treatment, a better policy would be to simply record the ineffective portion of a hedge in earnings (i.e., a proportionate approach versus an all-or-nothing approach). We are also aware of the FASB’s derivatives project in this area.

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If one or both of the justifications above apply, we believe that the provision of alternative accounting principles should be coupled with a long-term plan by the FASB to eliminate the alternative(s) through the use of sunset provisions. In addition, the effect of applying the alternative policy not selected by preparers should be clearly and succinctly communicated to investors (e.g., through footnote disclosure).

Further, as new guidance is issued, including that which is issued through the convergence process, the SEC should eliminate its alternative accounting policies in related areas, if any.

For the sake of clarity, we distinguish our recommendation to minimize alternative accounting policies here from the application of reasonable judgments discussed in chapter 3. In that context, differences may result from the absence of on-point guidance for certain transactions when companies apply U.S. GAAP by analogy. Similarly, differences may stem from the application of a single standard.<sup>98</sup> In contrast, our recommendation advises against expanding the number of free choices included in U.S. GAAP, such as whether or not to apply pension smoothing. This minimizes diversity at the outset of the financial reporting process, while recognizing some diversity in practice is unavoidable. It also reflects our belief that investors are better served by favoring consistency over diversity in the professional standards themselves.

From an international perspective, we note that IFRS currently permits numerous alternative accounting policies. While we acknowledge the IASB's efforts in reducing some of these alternative treatments, we nonetheless believe the SEC should encourage the IASB to be mindful of this recommendation, and seek to eliminate alternatives as part of its standards-setting projects. Further, we believe that it is not helpful for particular countries or regional compacts to adopt jurisdictional variants of IFRS as issued by the IASB, but recognize these matters are beyond the control of the IASB.

#### **V.C. Scope Exceptions**

***Recommendation 1.8: U.S. GAAP should be scoped with sufficient precision to minimize the use of scope exceptions. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB be carefully scoped to minimize the use of exceptions. Any new projects should also seek to refine the scope of existing standards in relevant areas as a specific objective of those projects to minimize existing scope exceptions.***

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<sup>98</sup> For instance, competing views as to whether a transfer of mortgages to a separate entity represents a sale or secured borrowing arrangement under Statement 140.

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## **Background**

Scope exceptions represent departures from the application of a principle to certain transactions. For example:<sup>99</sup>

- SFAS No. 133 excludes certain financial guarantee contracts, employee share-based payments, and contingent consideration from a business combination, among others
- SFAS No. 157 excludes employee share-based payments and lease classification and measurement, among others
- FIN 46(R) excludes employee benefit plans, qualifying special-purpose entities,<sup>100</sup> certain entities for which the company is unable to obtain the information necessary to apply FIN 46(R), and certain businesses, among others.

Similar to other exceptions to general principles, scope exceptions arise for a number of reasons. These include: (1) the issuance of guidance that imprecisely articulates the scope of a standard, resulting in unintended consequences, (2) cost-benefit considerations, (3) the need for temporary measures to quickly minimize the effect of unacceptable practices, rather than waiting for a final “perfect” standard to be developed, (4) avoidance of conflicts with standards that would otherwise overlap, and (5) political pressure.

Scope exceptions contribute to avoidable complexity in several ways. First, where accounting standards specify the treatment of transactions that would otherwise be within the scope, exceptions may result in different accounting for similar activities (refer to the discussion on competing models in section V.D. of this chapter). Second, scope exceptions may contribute to avoidable complexity because of difficulty in defining the bounds of the exception. As a result, scope exceptions require detailed analyses to determine whether they apply in particular situations, and consequently, increase the volume of accounting literature. For example, the Derivatives Implementation Group has issued guidance on twenty implementation issues related to the scope exceptions in SFAS No. 133. Further, companies may try to justify aggressive accounting by analogizing to scope exceptions, rather than more generalized principles.

Nonetheless, scope exceptions may alleviate complexity in situations where the costs of a standard outweigh the benefits. For example, many constituents would contend that derivative accounting and disclosures for “normal purchases and normal sales” contracts are not meaningful, and thus, are appropriately excluded from the scope of SFAS No. 133.<sup>101</sup> We recognize the benefit of “practical cuts” such as these, some of which are

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<sup>99</sup> Refer to appendix G for additional examples.

<sup>100</sup> We note that the FASB has tentatively decided to remove the qualifying special-purpose entity concept from U.S. GAAP and its exception from consolidation.

<sup>101</sup> See, e.g., comment letter from Institute of Management Accountants (October 3, 2007).

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identified during the development of a standard, and others that become apparent after the standard is put into practice.

### Discussion

We believe complexity resulting from scope exceptions may be minimized through more careful consideration of the scope of new projects.<sup>102</sup> In this regard, we believe improvements to the standards-setting process that are discussed in chapter 2 will be helpful, such as more effective cost-benefit analyses, field tests, and field visits. Even with more precise project scoping, we still expect continued demand for exceptions.

We believe these demands should be resisted, particularly when they represent political pressure. Nonetheless, we also acknowledge their practical merit in circumstances such as: (1) cost-benefit considerations, (2) the need for temporary measures to quickly minimize the effect of unacceptable practices, rather than waiting for a final “perfect” standard to be developed, and (3) the need for temporary measures to avoid conflicts in U.S. GAAP. But in cases where scope exceptions are provided as a temporary measure, they should be coupled with a long-term plan by the FASB to phase them out through the use of sunset provisions.

We also note that in certain areas, the SEC staff has issued guidance to address transactions that are not within the scope of FASB guidance (e.g., literature addressing the balance sheet classification of redeemable preferred stock not covered by SFAS No. 150).<sup>103</sup> Accordingly, as the FASB develops standards to address these transactions, the SEC should eliminate its related guidance.

From an international perspective, we note that IFRS currently has fewer scope exceptions than U.S. GAAP. We encourage the SEC to affirm the IASB’s efforts in this regard. However, we also note that, in certain circumstances where IFRS includes scope exceptions, they are sometimes more expansive than those under U.S. GAAP. For example, IFRS 3, *Business Combinations*, scopes out business combinations involving entities under common control, which results in no on-point guidance for such transactions. Accordingly, where IFRS provides scope exceptions, the SEC should encourage the IASB to ensure any significant business activities that are excluded from one standard are in fact addressed elsewhere. Said differently, the IASB should avoid leaving large areas of business activities unaddressed in its standards.

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<sup>102</sup> See, e.g., testimony from Ben Neuhausen (May 2, 2008).

<sup>103</sup> *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.

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## **V.D. Competing Models**

***Recommendation 1.9: U.S. GAAP should be based on a presumption that similar activities should be accounted for in a similar manner. As such, the SEC should recommend that any new projects undertaken jointly or separately by the FASB should not create additional competing models, except in rare circumstances. Any new projects should also include the elimination of competing models in relevant areas as a specific objective of those projects, except in rare circumstances.***

### **Background**

Competing models are distinguished here from alternative accounting policies. Alternative accounting policies refer to different accounting treatments that preparers are *allowed to choose* under existing U.S. GAAP (e.g., whether to apply the direct or indirect method of cash flows). By contrast, competing models refer to *requirements to apply* different accounting models to account for similar types of transactions or events, depending on the balance sheet or income statement items involved.

Examples of competing models include:<sup>104</sup>

- Different *methods* of impairment testing for assets such as inventory, goodwill, and deferred tax assets<sup>105</sup>
- Different *levels of asset aggregation* to conduct impairment tests and comply with disclosure requirements, such as asset groups, reporting units, operating segments, and reportable segments<sup>106</sup>

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<sup>104</sup> Refer to appendix G for additional examples.

<sup>105</sup> For instance, inventory is assessed for recoverability (i.e., potential loss of usefulness) and remeasured at the lower of cost or market value on a periodic basis. To the extent the value of inventory recorded on the balance sheet (i.e., its “cost”) exceeds a current market value, a loss is recorded. In contrast, goodwill is tested for impairment annually, unless there are indications of loss before the next annual test. To determine the amount of any loss, the fair value of a “reporting unit” (as defined in U.S. GAAP) is compared to its carrying value on the balance sheet. If fair value is greater than carrying value, no impairment exists. If fair value is less, then companies are required to allocate the fair value to the assets and liabilities in the reporting unit, similar to a purchase price allocation in a business combination. Any fair value remaining after the allocation represents “implied” goodwill. The excess of actual goodwill compared to implied goodwill, if any, is recorded as a loss. Deferred tax assets are tested for realizability on the basis of future expectations. The amount of tax assets is reduced if, based on the weight of available evidence, it is more likely than not (i.e., greater than 50% probability) that some portion or all of the deferred tax asset will not be realized. Future realization of a deferred tax asset ultimately depends on the existence of sufficient taxable income of the appropriate character (e.g., ordinary income or capital gain) within the carryback and carryforward periods available under the tax law.

<sup>106</sup> Asset groups are defined in SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, to test long-lived assets (e.g., property, plant, and equipment) for impairment. Reporting units are defined in SFAS No. 142, *Goodwill and Other Intangible Assets*, to test goodwill for impairment.

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- Different methods of revenue recognition in the absence of a general principle, and
- The derecognition of most liabilities (i.e., removal from the balance sheet) on the basis of legal extinguishment compared to the derecognition of a pension or other post-retirement benefit obligation via settlement, curtailment, or negative plan amendment.

Similar to other exceptions to general principles, competing models arise for a number of reasons. These include: (1) scope exceptions, which, as discussed above, arise from cost-benefit considerations, temporary measures, and political pressure, and (2) the lack of a consistent and comprehensive conceptual framework, which results in piecemeal standards-setting.

Competing models contribute to avoidable complexity in that they lead to inconsistent accounting for similar activities, and they contribute to the volume of accounting literature.

On the other hand, competing models alleviate avoidable complexity to the extent that costs of a certain model exceed the benefits for a subset of activities.

### Discussion

We believe that similar activities should be accounted for in a similar manner. Nonetheless, we acknowledge that competing models may be justified in two circumstances: (1) where the costs of applying a certain model to a subset of activities exceed the benefits and (2) as temporary measures (that are eventually phased out) to minimize the effect of unacceptable practices quickly, rather than waiting for a final “perfect” standard to be developed. To the extent a competing model meets one or more of the justifications above, scope exceptions could be used to clarify which accounting models cover various transactions (e.g., standard A ought to refer preparers to standard B for transactions excluded from the scope of A).

We recognize that the FASB and IASB’s joint project on the conceptual framework will alleviate some of the avoidable complexity caused by competing models. However, we would encourage the implementation of this recommendation prior to the completion of conceptual framework, where practical because: (1) the conceptual framework is a long-term project and (2) current practice issues encountered in the standards-setting process will inform deliberations on the conceptual framework.

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Operating segments and reportable segments are defined in SFAS No. 131 for purposes of disclosure; they are also used to define reporting units in SFAS No. 142.

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Further, as new accounting standards are issued, including that which is issued through the convergence process, any competing models in related SEC literature should be revised and/or eliminated, as appropriate.

We note IFRS also contains competing models. Accordingly, we believe the SEC should encourage the IASB to be mindful of this recommendation, particularly as it works with the FASB on the joint conceptual framework.

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## CHAPTER 2: STANDARDS-SETTING PROCESS

### I. Introduction

A robust accounting standards-setting process (standards-setting) is the foundation of an efficient system of financial accounting and reporting, on which capital providers may rely to make investment decisions. Although the U.S. approach to financial reporting has been quite effective in achieving that overarching objective, U.S. GAAP has evolved over many years to a point where some of its basic principles are obfuscated by detailed rules, interpretations, exceptions, and alternatives that collectively reduce the usefulness of the resulting financial reporting. Historically, interpretative rules on how to implement U.S. GAAP (interpretive implementation guidance) have proliferated from a variety of sources and, intentionally or not, have often become perceived as additional U.S. GAAP. This increases the complexity of the financial reporting system and reduces its transparency, especially when questions exist about the authoritative nature of such guidance or conflicts exist between interpretations.

This chapter advances recommendations intended to alleviate some of these concerns. Specifically, after examining the U.S. standards-setting process, we recommend changes to:

- Increase the consideration of investor perspectives in standards-setting
- Enhance governance and oversight
- Improve the process of setting standards
- Clarify the role of interpretive implementation guidance
- Improve the design of standards going forward.

In general, we believe the design of the U.S. standards-setting process, including the process of issuing authoritative interpretive implementation guidance, and the role played by each participant are appropriate. However, refinements may be made to existing processes that may significantly influence behaviors and thereby help financial reporting better serve the needs of investors. As investors are the primary consumers of financial reports, standards-setting would be greatly improved if their perspectives were better integrated into standards-setting through increased investor involvement throughout the process.

Some of our recommendations may be partially or substantially addressed by actions recently taken, or in the process of being taken, by the Financial Accounting Foundation (FAF), the FASB, and the SEC, the impacts of which may not yet be fully realized or apparent. We reference these impacts where applicable. Other aspects of our recommendations may occur in practice, but may not be well understood or consistently applied. Our recommendations are designed to increase the transparency and effectiveness of these processes.

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## **II. International Considerations**

As noted earlier in our report, we do not advance detailed recommendations regarding the best means for accomplishing the convergence of international accounting standards. Rather, recognizing that there are various paths to convergence and that it may take years to achieve, our recommendations presume that U.S. GAAP will exist for a number of years. However, if the SEC were to act to move domestic registrants in the U.S. to IFRS in the near-term, by necessity either the prioritization of many of our recommendations would be different or they would require reconsideration. As such, this chapter comments on how some of our standards-setting recommendations may be impacted by efforts for convergence of international accounting standards currently being considered in the U.S.

Regarding the standards-setting process itself, our mandate focuses on recommending improvements to U.S. processes, which may be informed by best practices internationally. An explicit analysis of how international standards-setting could be improved was not in our purview. Nevertheless, we believe the principles underpinning our recommendations may be equally applicable in any high-quality standards-setting regime.

## **III. Investor Perspectives**

***Recommendation 2.1: Investor perspectives are critical to effective standards-setting, as investors are the primary consumers of financial reports. Only when investor perspectives are properly considered by all parties does financial reporting meet the needs of those it is primarily intended to serve. Therefore, investor perspectives should be given pre-eminence<sup>107</sup> by all parties involved in standards-setting. Although it is more challenging to obtain investor perspectives than those of other constituents involved in the standards-setting process, additional investor representation would facilitate increased consideration of investor perspectives in the standards-setting process. Specifically, the SEC should recommend that the FAF and the FASB do the following:***

- ***Add investors to the FAF to give more weight to the views of different types of investors, both large and small***
- ***Give more representation on both the FASB and the FASB staff to experienced investors to improve consideration of the usefulness of financial reports***

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<sup>107</sup> [We recognize the need for balance among all parties involved in the standards-setting process. We do not intend to suggest by this recommendation that investor input trumps all others. Instead, in cases where constituent views cannot be reconciled, we believe that the investor perspective should be afforded greater weight.]

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- ***Re-evaluate the manner, timing, and quality of investor input received throughout standards-setting to determine whether changes would be warranted to make investor involvement more efficient and effective.***

### **Background**

Consideration of investor perspectives throughout standards-setting is critical. The current standards-setting process does attempt to balance the views of different stakeholders, but investor perspectives are often under-represented, because the intricacy of standards-setting often makes it difficult to elicit continued investor participation as compared to other constituents. In recent years, the FASB has undertaken significant efforts to increase investor participation in standards-setting. Specifically, the FASB created a number of new investor advisory groups, added investors to existing advisory and other groups, made greater use of project-specific resource groups, and engaged in more focused constituent outreach at all stages of standards-setting. Our recommendation is intended to supplement those recent efforts to provide the FASB with more formal, efficient, and timely feedback from investors, both large and small.

Contemporaneous with our review of the standards-setting process in the U.S., the FAF engaged in a similar review.<sup>108</sup> Our Progress Report advanced draft proposals that the FAF considered, along with comment letters received from its constituents, in reaching its final conclusions.<sup>109</sup> Specific to recommendation 2.1, the FAF expanded the sources of FAF Trustee nominations (subject to the need to consider implementation issues), reduced the size of the FASB from seven to five members effective July 1, 2008, and affirmed the need for investor participation on the FASB by amending its by-laws to require that all FASB members “have knowledge of and experience in investing, accounting, finance, business, accounting education and research and a concern for the investor and the public interest in matters of investing, financial accounting and reporting.” Notwithstanding our general support for these resolutions, our final recommendation is reflective of areas we believe warrant further consideration.

### **Discussion**

We believe the financial reporting system would best be served by recognizing that the perspectives of investors should be pre-eminent because all stakeholders benefit from a system that allocates capital more efficiently. Some disagree with the notion of one constituent group having pre-eminence, because doing so might create an imbalance in

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<sup>108</sup> FAF, *Request for Comments on Proposed Changes to Oversight, Structure and Operations of the FAF, FASB and GASB* (December 18, 2007).

<sup>109</sup> FAF, *Corporate Governance Changes to Oversight, Structure, and Operations of the FAF, FASB and GASB: Recitals and Resolutions Adopted by the FAF Board of Trustees on 02-26-08*.

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standards-setting.<sup>110</sup> Our recommendation is intended to promote the appropriate balance of constituent views by underscoring that all participants in standards-setting should have an investor focus in developing and administering a well-designed and effective system of financial reporting. This notion was captured by the FAF in its recent changes to the FASB by-laws. We also believe increasing investor representation in standards-setting will enhance their participation and consideration of investor perspectives, thereby improving the overall investor focus of financial reporting.

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### ***FAF***

Our recommendation complements the FAF's recent governance reforms, but we believe additional investor representation on the FAF should be emphasized. Such representation should strive to consider differing perspectives in the investor community.

### ***FASB and FASB Staff***

Given the FAF's reduction in the size of the FASB from seven to five members, we support the current composition of the Board, which includes members whose primary professional experience is as investors, preparers, auditors, and academics. Board members should be selected from the most qualified individuals who possess a breadth of experiences that will ensure that the perspectives of investors are carefully considered and given pre-eminence when attempting to balance the perspectives of other constituents. However, increasing direct investor involvement on the Board would bring investor perspectives to the forefront of standards-setting and the process of issuing interpretive implementation guidance. We encourage the FAF to increase the representation of investors as future Board positions become available. Specifically, we recommend that the composition of the Board include no fewer than one, and ideally more than one, member whose primary professional experience is as an investor and who is also well-versed in the conceptual foundations of accounting.

We recognize that a reduction in the size of the Board may create a workload capacity concern, but we understand the FASB is already taking steps to mitigate this concern, by, for example, being more selective when accepting Board member speaking engagements and by making greater use of webcasts to ensure maximum outreach. We believe that this concern may be further allayed by delegating more responsibilities to senior staff members and by possibly increasing the size of the FASB staff. In addition, the FAF and FASB should consider staffing alternatives that make use of part-time senior staff for particular projects or purposes.

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<sup>110</sup> See, e.g., comment letters from BDO Seidman, LLP (March 31, 2008); the Center for Audit Quality (March 31, 2008); Deloitte & Touche LLP (March 31, 2008); Ernst & Young LLP (March 31, 2008); KPMG LLP (March 31, 2008); and PricewaterhouseCoopers LLP (March 31, 2008).

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There may be opportunities to increase investor representation on the FASB staff, as well. The FASB has permanent staff with professional investing experience and has had a fellowship program for many years, although fellows usually come from the auditor and preparer communities. The FASB has approached investors and investor groups about the possibility of sponsoring fellows, but thus far has had limited success. The FASB's effectiveness may be enhanced by fellows sponsored by the investor community, and we encourage continued efforts to identify qualified candidates to serve in this capacity.

#### ***Other Investor Involvement***

As noted above, the FASB has greatly improved its investor outreach in the past few years. However, there may be opportunities to further increase the involvement of and more effectively utilize investors so that they know when and how to engage the FASB and its staff to assist in standards-setting. Specifically, the FASB should re-evaluate its advisory and other groups to determine whether investor involvement is efficient and effective. By reconsidering which investors should participate in each group, the FASB may better attract advice or detailed technical assistance, as the situation requires, from investors with the right background and experience at the right time. Similarly, clarifying which investor groups the FASB should consult on different types of issues and with what frequency would likely increase the efficiency and effectiveness of investor participation in standards-setting for all involved parties.

In addition, the FASB should incorporate into its standards-setting process a formal mechanism to obtain high-level investor feedback on new standards before they are exposed for public comment. To achieve that objective, the FASB could re-evaluate the role and composition of its User Advisory Council (UAC). A reconstituted UAC could serve as a pre-committed panel of diverse investors who could conduct pre-issuance reviews of proposed standards. The objective of such formalized investor reviews would be to timely assess and provide feedback on perceived investor benefits associated with a proposed new standard in its entirety (including whether investors believe that the proposed new standard would provide better information than what is currently available) and propose alternative or less costly solutions, when appropriate. However, such a formalized review should not inhibit the frequent and ongoing dialogue between the standards-setter and its advisory or other groups throughout the standards-setting process.

#### **IV. FAF and FASB Governance**

***Recommendation 2.2: The SEC should continue to recommend that the FAF enhance governance of the FASB, as follows:***

- ***Recommend that the FAF amend the FASB's mission statement, stated objectives, and precepts to emphasize that an additional goal should be to minimize avoidable complexity***

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- ***Recommend that the FAF develop performance metrics to ensure that key aspects of the standards-setting process are effective, efficient, and compliant with the goals in the FASB's mission statement, objectives, and precepts.***

### **Background**

The FAF is responsible for the oversight and appointment of Board members of the FASB and the GASB. While the FAF does not direct the standards-setting activities of the FASB, it does have a responsibility to periodically review the FASB's structure and governance to assess its effectiveness and efficiency. The FAF has always maintained oversight of the FASB as one of its main priorities. Our recommendation is designed to promote more active FAF oversight of the FASB – in order to improve the efficiency and effectiveness of standards-setting.

As noted above, the FAF recently implemented various changes in its oversight of the FASB. Specific to recommendation 2.2, the FAF changed the terms of service of Trustees, created flexibility in the size of the FAF itself, retained FASB simple majority voting, and assumed a more active oversight role that includes monitoring the efficiency and effectiveness of standards-setting. Notwithstanding our general support for these resolutions, our final recommendation is reflective of areas we believe warrant further consideration.

### **Discussion**

#### ***Mission and Objectives***

The FASB's mission statement, objectives, and precepts acknowledge that efficient capital markets rely on credible, concise, and understandable financial information. They also recognize the importance of the following:

- Improving the usefulness of financial information by focusing on relevance, reliability, comparability, and consistency
- Keeping standards current
- Considering promptly significant areas of deficiency that need improvement
- Promoting international convergence
- Improving the understanding of the nature and purpose of information in financial reports
- Being objective in decision-making and promoting neutrality of information
- Weighing carefully the views of constituents
- Satisfying the cost-benefit constraint
- Minimizing disruption by providing reasonable effective dates and transition provisions

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- Reviewing the effects of past decisions in a timely fashion to interpret, amend, or replace standards, when necessary
- Following an open, orderly process for standards-setting.

We believe minimizing avoidable complexity should be added to this list. Although we do not believe the FASB sets out to issue complex standards, amending the mission statement, stated objectives, and precepts may promote more explicit consideration of less complex accounting alternatives by all participants in standards-setting.

### ***Performance Metrics***

The recent FAF changes seek to increase its active oversight of the FASB. We support these improvements, but we note that the FAF has not described how it intends to implement them. Many of the recommendations in this chapter provide input regarding how and in what areas to strengthen such oversight. The FAF should develop performance metrics to assess the FASB's adherence to the goals in its mission statement, objectives, and precepts. These metrics should track the timeliness and effectiveness of the FASB's standards-setting process, including, but not limited to, the efficiency and effectiveness of cost-benefit analyses, field visits, field testing, and Board consideration of public comments.

The FAF and FASB are best positioned to agree on what performance metrics would be appropriate to implement. A number of not-for-profit organizations have implemented service effort performance metrics that the FAF and FASB may consider when designing their own metrics. The active monitoring of such metrics would not have a detrimental impact on the FASB's independence; rather, they are intended to improve accountability associated with the process of standards-setting.

## **V. Standards-Setting Process Improvements**

***Recommendation 2.3:*** *The SEC should recommend that the FAF, the FASB, and other participants in the financial reporting system continue to improve the effectiveness, efficiency, and timeliness of standards-setting, as follows:*

- ***Create a Financial Reporting Forum (FRF) that includes key constituents from the preparer, auditor, and investor and other user communities, to meet with representatives from the SEC, the FASB, and the PCAOB to discuss pressures in the financial reporting system overall, both immediate and long-term, and how individual constituents are meeting these challenges. This may require the FASB to re-evaluate the roles and composition of other advisory groups or agenda committees.***
- ***Enhance the consistency and transparency of key aspects of the FASB's field work, including cost-benefit analyses, field visits, and field tests.***

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- *Formalize post-adoption reviews of each significant new standard to address interpretive questions and reduce the diversity of practice in applying the standard, if needed.*
- *Formalize periodic assessments of existing accounting and related disclosure standards to keep them current.*

### **Background**

U.S. standards-setting involves significant due process. The FASB's activities are open to public participation and observation, and the FASB actively solicits the views of its various constituents on accounting issues. We believe the FASB's approach to obtaining significant input through its open due process is appropriate, although there is a difficult trade-off between a transparent due process and expediency. Although we believe the FASB's processes function well and we acknowledge the significant improvements made recently, further refinements to existing processes could improve the effectiveness, efficiency, and timeliness of standards-setting.

### ***Agenda***

Some assert that it may take too long for the issuance of new accounting standards or interpretive implementation guidance in response to changes in business practices or the economic environment.<sup>112</sup> As noted above, the FAF recently implemented various changes in its oversight of the FASB. Specific to agenda-setting, the FAF instituted a leadership agenda at the FASB, whereby the FASB Chairman, following appropriate consultation and subject to oversight from the FAF, sets the FASB's agenda and the priority of projects. We understand that through the new leadership agenda, the FASB has recently taken steps to re-align its agenda to more effectively meet its dual (and potentially competing) standards-setting goals of international convergence and of maintaining, improving, and simplifying U.S. GAAP. For example, the FASB has removed less active projects from its agenda to redirect its resources to current projects that are meant to address immediate practice issues. We support continued and ongoing efforts in that regard. Notwithstanding our support for these efforts, our final recommendation is reflective of areas we believe warrant further consideration.

### ***Standards-setting Process***

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<sup>112</sup> See, e.g., comment letters from the Center for Audit Quality (November 20, 2007); the Equipment Leasing and Finance Association (October 10, 2007); Ernst & Young LLP (March 31, 2008); FirstEnergy Corp. (March 31, 2008); KPMG LLP (March 31, 2008); and UBS AG (March 31, 2008).

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Due to its practice of being very open to constituent input, the FASB often receives conflicting advice. Further, even though the FASB has a transparent due process, new standards are often met with requests for interpretive implementation guidance, implementation deferral, or amendment. Some assert that new standards are not always internally consistent or may be more complex to apply than is necessary to achieve the desired objective.<sup>113</sup> We acknowledge that various factors impact the development of new standards, including the lack of a completed conceptual framework, competing priorities placed on the Board, opposing views expressed by different constituents, the desire for detailed guidance that answers every implementation issue, and the evolutionary nature of standards-setting in the U.S. At the same time, we note that, while some of these factors are not in the Board's control, others are.

As noted above, the FAF recently implemented various changes in its oversight of the FASB. Specific to other aspects of standards-setting, the FAF assumed a more active oversight role (including the possibility of the FASB formalizing a post-implementation standards review process and the FAF monitoring the efficiency and effectiveness of standards-setting). Notwithstanding our general support for this resolution, our final recommendation is reflective of areas we believe warrant further consideration.

### Discussion

#### FRF

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Some express concern that the responsibilities of the proposed FRF would overlap with those of FASB advisory and other groups.<sup>114</sup> We acknowledge that the creation of the FRF may necessitate a re-evaluation by the FAF and the FASB of the composition and responsibilities of other FASB advisory groups and agenda committees, as well as when and what input is requested of them, to avoid overlapping responsibilities. For example, involvement of preparers, auditors, and investors and other users could be effectuated by

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<sup>113</sup> See, e.g., comment letters from BDO Seidman, LLP (March 31, 2008); the Center for Audit Quality (November 20, 2007); Ernst & Young LLP (March 31, 2008); Financial Executives International – Committee on Corporate Reporting (September 26, 2007 and April 4, 2008); Financial Executives International – Committees on Small and Mid-Sized Public Companies and on Finance & Information Technology (March 31, 2008); and the Institute of Management Accountants (October 3, 2007).

<sup>114</sup> See, e.g., comment letters from the Center for Audit Quality (March 31, 2008); the CFA Institute Centre for Financial Market Integrity (March 31, 2008); Ernst & Young LLP (March 31, 2008); Financial Accounting Standards Advisory Council (March 31, 2008); Financial Executives International – Committee on Corporate Reporting (April 4, 2008); Fitch Ratings, Inc. (April 2, 2008); KPMG LLP (March 31, 2008); PricewaterhouseCoopers LLP (March 31, 2008); UBS AG (March 31, 2008); and Terry D. Warfield, University of Wisconsin (February 4, 2008).

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leveraging members or executive committees from existing FASB or PCAOB advisory groups and agenda committees.<sup>115</sup>

Further, we would not limit the proposed FRF's purview solely to the work of the FASB. Rather, key constituents in the U.S. financial reporting system would meet with representatives from the SEC, the FASB, and the PCAOB to confer on immediate financial reporting needs and priorities system-wide. By identifying emerging issues, the FRF would give timely input on pressures affecting the financial reporting system, both immediate and long-term.

Our recommendation complements the FAF's recent decision to change the FASB's agenda-setting process by establishing a leadership agenda. We believe instilling more decision-making authority in the FASB Chairman, combined with a requirement to consult with the proposed FRF, would be a positive step toward increasing the efficiency and effectiveness of the financial reporting system at large. If the SEC acts to move domestic issuers to IFRS in the future, the FRF could also serve as a useful mechanism to identify U.S. financial reporting issues that may need consideration for international standards-setting.

In creating such a proposed FRF, the SEC, the FAF, the FASB, and the PCAOB should consider ways to implement the following objectives:

- Timeliness and transparency – Urgent matters in the U.S. financial reporting system should be dealt with in a timely fashion, which may require the FRF to be convened both on a regular schedule and on short notice, as necessary. The meeting process should allow interested parties to raise issues in a transparent fashion.
- Active participation – One or more key decision-makers from the SEC, the FASB, and the PCAOB should participate on the FRF. This could encourage coordination among the parties of how and by whom guidance should be issued, thereby reducing the impetus for the SEC to issue interpretive implementation guidance separately from the codified version of U.S. GAAP (see section VI of this chapter). Representation from preparers, auditors, and investors and other users could be effectuated by leveraging members or executive committees from existing FASB or PCAOB advisory groups and agenda committees, but all parties should maintain an appropriate focus on investor and other user needs.

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### *Field Work*

The FASB has an extensive process for developing and soliciting investor and other feedback on new standards. Field work generally includes performing cost-benefit

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<sup>115</sup> See, e.g., comment letters from the Center for Audit Quality (March 31, 2008); Ernst & Young LLP (March 31, 2008); and PricewaterhouseCoopers LLP (March 31, 2008).

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analyses, field visits, and other outreach before the standard is exposed for public comment and may include field tests, during which the implementation of a new standard is beta tested. With respect to cost-benefit analyses, participants in standards-setting have long acknowledged that reliable, quantitative cost-benefit calculations are seldom feasible, in large part because of the difficulty of quantifying the benefits and estimating costs prior to implementation. As a result, cost-benefit analyses are sometimes based largely on non-quantitative input received in various ways throughout standards-setting, including field visits, field tests, public comments, and other constituent outreach. To varying degrees, the process for obtaining the input and the extent to which the cost-benefit analyses are documented and communicated in the standards differs across projects.

To enhance the effectiveness of field work, the FASB should implement improvements so that the approach for performing field work is more consistent and transparent across all projects. The work performed should be reasonable in relation to the difficulty and length of time required to implement the proposed standard and the magnitude of its potential impact, should leverage the resources and subject matter expertise available through FASB advisory and other groups, and should consider the work performed by others. Whenever practicable, all aspects of field work should occur concurrently, to improve the efficiency of the process used to obtain and evaluate constituent input. To enhance transparency around that process, the FASB should also improve its documentation of field work (for example, in the basis for conclusions of both exposure drafts and final standards).

Some express concern that introducing enhanced field work processes may impede the timeliness of standards-setting.<sup>116</sup> By increasing the effectiveness and efficiency of field work, we believe improved timeliness will result. Further, although enhanced processes may be time consuming, we believe by identifying and addressing implementation issues prior to issuing new standards, the FASB would reduce the amount of time spent considering possible interpretive implementation guidance, implementation deferrals, or amendments to standards.

We acknowledge the significant amount of time required to perform field work, but we understand the FASB is currently considering improvements to the consistency and transparency of its cost-benefit procedures that will not significantly increase the level of effort involved. We also understand that the FASB plans to make greater use of roundtables, surveys, and other research, which together may satisfy our recommendation. Roundtables have an advantage over traditional field work, because

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<sup>116</sup> See, e.g., comment letters from the CFA Institute Centre for Financial Market Integrity (March 31, 2008); the Council of Institutional Investors (March 31, 2008); Fitch Ratings, Inc. (April 2, 2008); and UBS AG (March 31, 2008).

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they provide an ideal opportunity to vet issues raised in comment letters through active debate between and among various constituents, promoting balanced standards-setting in an efficient manner with maximum Board involvement. We support these efforts and recommend that the FASB give further consideration to these and other improvements when assessing whether a compromise between doing no field testing and full-scale beta adoptions of new standards would be possible. The success of these efforts will in large part be determined by the willingness of participants in the financial reporting community to provide appropriate information and assistance to the standards-setter.

As noted in section IV of this chapter, the FAF should also develop key performance metrics to track the timeliness and effectiveness of the FASB's standards-setting process, including, but not limited to, the effectiveness and efficiency of field work.

#### ***Post-Adoption Reviews of New Standards***

We acknowledge that it is impossible to identify and address all implementation issues in a new standard prior to it being issued and adopted. Issues and questions are often identified during the initial implementation phase as preparers and auditors begin to apply a new standard in practice. Preparers, auditors, and others often monitor and take measures to reduce diversity in practice when implementing a new standard by conferring among themselves and issuing non-authoritative interpretive implementation guidance. During this initial period, requests are often made of the FASB, the EITF, and the SEC to provide interpretive implementation guidance for new standards.

In the current financial reporting environment, preparers and auditors are sometimes viewed as being penalized for implementing their understanding of new accounting standards immediately after adoption. This is because any ambiguity or substantial gaps identified in the implementation period may lead the regulators to issue interpretive implementation guidance that differs from conclusions originally reached by the preparers and auditors.

The FASB has a process in place to timely identify and respond to implementation issues for new accounting standards, including through the EITF and ongoing constituent outreach involving FASB advisory groups and others. To enhance its effectiveness, the FASB should formalize post-adoption reviews so that they are performed for each significant new standard within a reasonable period following its effective date in a transparent fashion. The review objective should be to assess whether the standard is accomplishing its intended purpose (or whether there are unintended consequences that need to be resolved through standards-setting or in other ways). We do not believe that a specified time period for conducting post-adoption effectiveness reviews should be prescribed, as we believe the standards-setter and its advisory groups should evaluate the facts and circumstances surrounding each major project when making such determinations.

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We believe that, when necessary, interpretive implementation guidance for new standards that may result from these reviews is best given by the FASB using:

- A transparent due process with public comment
- Appropriate transition guidance, timing, and required disclosures that will provide investors and other users with useful information regarding possible changes in accounting
- The codified version of U.S. GAAP.

Understandably, some interpretive implementation guidance may be of such an urgent nature that a transparent due process would not be responsive to the needs of investors and other users. Therefore, we envision that the SEC would only issue interpretive implementation guidance in limited situations (see section VI of this chapter).

Our recommendation does not contemplate that preparers would have the flexibility to implement new standards at different times or have the ability to adopt early or late. Following the recent policy decision by the FASB that discourages early adoption of new standards for comparability reasons, our recommendation contemplates transition guidance for a new standard with a stated, required implementation date. Similarly, this recommendation is not a safe harbor. Nor does it constitute a policy to forebear on enforcing new accounting standards. Violations of U.S. GAAP will continue to be dealt with by the SEC through the review, comment, restatement, and enforcement processes. However, the SEC should give appropriate consideration to situations in which there are ambiguities or gaps in a new standard that could be subject to more than one reasonable interpretation. For example, it may be inappropriate for the SEC to bring an enforcement proceeding based on a new accounting standard if, after careful analysis performed in good faith, the registrant took a reasonable and supportable view of that standard, which was subsequently changed by formal amendment or published interpretation. On the other hand, a registrant that fails to follow well-defined aspects of a new accounting standard should not be able to defend such actions by arguing that the standard was new and subject to possible revision.

#### *Periodic Assessment of Existing Standards*

After an accounting standard has been in place for a reasonable period, more data is likely to be available to evaluate its benefits and costs. Further, economic conditions and business practices may change over time, such that older accounting standards may lose their relevance and effectiveness. Some note that numerous accounting standards or

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models need immediate re-evaluation.<sup>117</sup> For example, in today's economic environment, the accounting for securitizations and structured products with off-balance-sheet risk is cited as needing re-evaluation.<sup>118</sup> The accounting for convertible debt and derivatives and hedging activities is also frequently cited as areas for improvement.

Having current accounting standards in place is critical to the proper functioning of the U.S. capital markets. The FASB has a process in place to timely identify and respond to questions that arise for existing standards, including through the EITF and ongoing constituent outreach involving FASB advisory groups and others. To enhance its effectiveness, the FASB should formalize its reviews of existing standards so that they continue to be useful in the current economic and business environment. Such assessments should be systematic and incorporate procedures to periodically request feedback from a broad range of constituents, including the SEC, about U.S. GAAP requirements that create practice problems or are unnecessarily complex in the current environment.

## **VI. Interpretive Implementation Guidance**

***Recommendation 2.4: The SEC should coordinate with the FASB to clarify roles and responsibilities regarding the issuance of interpretive implementation guidance, as follows:***

- ***To the extent practicable, going forward, there should be a single standards-setter for all authoritative accounting standards and interpretive implementation guidance that are applicable to a particular set of accounting standards, such as U.S. GAAP or IFRS. For U.S. GAAP, the FASB serves this function. To that end, the SEC should only issue broadly applicable interpretive implementation guidance in limited situations (see recommendation 2.5).***
- ***The FASB Codification, a draft of which was released for verification on January 16, 2008, should be completed in a timely manner. In order to fully realize the benefits of the FASB's codification efforts, the SEC should ensure that the literature it deems to be authoritative is integrated into the FASB Codification by following, to the maximum extent practicable, a format consistent with the one used by the FASB.***
- ***All other sources of interpretive implementation guidance should be considered non-authoritative and should not be required to be given more credence than***

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<sup>117</sup> See, e.g., comment letters from BDO Seidman, LLP (March 31, 2008); the Center for Audit Quality (November 20, 2007); the Council of Institutional Investors (March 31, 2008); the Institute of Management Accountants (October 3, 2007); and Sherman L. Rosenfield (October 13, 2007).

<sup>118</sup> SEC staff, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (June 2005).

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*any other non-authoritative sources that are evaluated using reasonable judgments made in good faith that are supportable under U.S. GAAP.*

- *The proposed FRF should advise the FASB on re-prioritizing its agenda in a way that balances the need for international convergence (which is highly dependent on possible future actions of the SEC), improvements to the conceptual framework, and maintaining existing U.S. GAAP. If U.S. GAAP will continue to be in use for an extended period of time, such a re-prioritization of standards-setting should consider the possibility of a second phase of the codification project to systematically revisit U.S. GAAP.*

### **Background**

Non-authoritative interpretive implementation guidance has proliferated over time from a variety of sources, which intentionally or not, has been viewed as additional authoritative U.S. GAAP. In other words, interpretive implementation guidance that is not formally authoritative often is erroneously perceived by participants in the financial reporting and legal communities to be quasi-authoritative. The key risks associated with a proliferation of interpretive implementation guidance are that: (1) the appropriate rule may not be identified and considered and (2) it may conflict with authoritative or other non-authoritative guidance, causing uncertainty in application and legal risk.

Over the past few years, the FASB and the SEC have taken steps intended to reduce the proliferation of interpretive implementation guidance from different authoritative bodies. For example, the SEC recognized the standards of the FASB as “generally-accepted,” and the FASB limited the ability of other bodies (e.g., the EITF,<sup>119</sup> the FASB staff, and others) to create authoritative guidance without FASB ratification. Nevertheless, the SEC staff continues to be a source of interpretive implementation guidance in its own right, through such vehicles as comment letters, staff speeches, SABs, and other forms of exchange that, although non-authoritative, are perceived as quasi-authoritative.

Our recommendation, which should be read in conjunction with recommendation 2.5, is designed to recognize recent accomplishments in this area, clarify what guidance is authoritative and non-authoritative, and further influence the behaviors that have led to the desire for more guidance.

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<sup>119</sup> Historically, the process of issuing authoritative interpretive implementation guidance in the U.S. rested primarily with the EITF. Formed and overseen by the FASB, the mission of the EITF is to reduce diversity in the application of U.S. GAAP by promulgating interpretive implementation guidance on a timely basis. The EITF was designed to minimize the need for the FASB to spend time and effort addressing narrow implementation, application, or other emerging issues that can be analyzed within existing U.S. GAAP.

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## **Discussion**

### ***FASB Codification***

The FASB has undertaken a significant project to develop a comprehensive, integrated Codification of existing accounting literature organized by subject matter that is intended to become an easily retrievable single source of U.S. GAAP. To that end, on January 16, 2008, the FASB released a draft of the FASB Codification that will be subject to a one-year verification period. We support the FASB's initiation of this project and recognize the significant effort it has entailed. The FASB Codification:

- Brings together all U.S. GAAP from all authoritative sources and classifies it by topic into a single, searchable database so that it may be more easily researched
- Clarifies what guidance is authoritative versus non-authoritative
- Puts accounting standards into a consistent format, to the extent practicable.

Although the FASB Codification does not change the substance of U.S. GAAP, it should make its application easier. However, SEC literature, which has developed through different mechanisms, is not as easily integrated into the FASB Codification.<sup>120</sup> Similarly, the FASB Codification does not deal with either the root causes of the proliferation of interpretive implementation guidance or the behavior of participants in the U.S. financial reporting community that caused the complexity. Notwithstanding these concerns, we support the FASB's efforts to verify the Codification. To further promote the benefits of the Codification, the SEC should codify its interpretive implementation guidance using a consistent format. If U.S. GAAP will continue to be in use for an extended period of time, the FASB and the SEC should consider systematically revisiting U.S. GAAP in a second phase of the codification project.

### ***Non-Authoritative Guidance***

Although the FASB Codification will help clarify the roles of authoritative and non-authoritative guidance, meaningful improvements in financial reporting will be difficult if non-authoritative interpretive implementation guidance continues to be perceived, as it is today, as having quasi-authority in the marketplace. Our recommendation is intended to foster acceptance of reasonable judgments made in good faith when they are supportable under U.S. GAAP. Specifically, non-authoritative interpretive implementation guidance should be clearly labeled as such and should not be used as the sole basis for forcing

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<sup>120</sup> Two of the benefits of the FASB Codification are its search feature and decimal system, which consistently organizes topics and subtopics in U.S. GAAP. To improve its usability in the future, the Codification includes authoritative content issued by the SEC, as well as selected SEC staff interpretations. However, the inclusion of SEC guidance is for administrative convenience and will not supersede such guidance in its current form. Further, the SEC guidance does not follow the same organizational structure as the rest of U.S. GAAP in the Codification.

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accounting treatments when other reasonable interpretations exist that are supportable under U.S. GAAP and are made in good faith.

### ***Priorities***

We acknowledge that the FASB contends with competing priorities and that its agenda over the next few years will be dominated by international convergence efforts. Therefore, we believe the financial reporting system would benefit from continuous input from the FRF proposed in section V of this chapter regarding both urgent matters and longer-term priorities in the financial reporting system overall.

### ***Second Phase of Codification***

As noted above, the Codification does not change the substance of U.S. GAAP, which continues to be encumbered by detailed rules, bright lines, scope exceptions, industry guidance, accounting alternatives, and other forms of complexity. Further, because of the evolutionary nature of U.S. standards-setting, the Codification does not read consistently in all parts. Even after the proposed re-codification of SEC literature, there will be opportunities to remove redundancies between SEC and FASB disclosure requirements and make other simplifications. Therefore, subject to the recommendation above that the FRF should advise the FASB on re-prioritizing its agenda given international convergence and other priorities, we believe the FASB and the SEC should perform a second phase of the codification project, which would involve a comprehensive assessment of existing accounting standards recommended in section V of this chapter. Specifically, the FASB should research opportunities to: (1) amend, replace, or remove outdated standards, (2) re-address frequent practice problems (as identified by restatement volumes, input from the SEC, implementation guidance issued, or frequently asked questions), (3) design standards more optimally (see section VII of this chapter), (4) rewrite the Codification to be less complex and more coherent after codification, where practicable, (5) remove conflicts between standards or with the conceptual framework, (6) remove redundancies between SEC disclosure requirements and other sources of U.S. GAAP (see recommendation 1.3), and (7) require disclosures based on a coherent disclosure framework (see recommendation 1.2) that should be added to the conceptual framework.

***Recommendation 2.5:*** *As a general matter, the SEC staff should refrain from issuing broadly applicable interpretive implementation guidance that would change U.S. GAAP and instead should refer such matters to the FASB, such as through the proposed FRF. The SEC staff should re-emphasize that its comment letter and “pre-clearance” processes are registrant-specific; other registrants should not necessarily change their accounting because they become aware of another comment letter, unless they conclude, on their own, that it is appropriate to do so. Furthermore, the SEC staff is taking a number of steps to improve the consistency*

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*of its interpretive implementation guidance associated with U.S. GAAP and the Commission should take appropriate steps to monitor the outcome of those actions.*

### **Background**

When the FASB issues new accounting standards or interpretive implementation guidance, it follows a rigorous notice and comment process. When the Commission adopts rules, including those that would comprise part of authoritative U.S. GAAP, its approval of those rules generally follows a similar public comment process.

Some express concern that the SEC staff may, at times, take actions that serve to interpret, revise, or add to U.S. GAAP without opportunities for public comment that should be associated with such actions.<sup>121</sup> In fact, the SEC staff usually does not engage in a public comment process before it issues interpretive implementation guidance. The SEC staff provides interpretive implementation guidance in at least three ways. First, the SEC staff has historically provided interpretive implementation guidance that is intended to be applicable to all registrants, such as in SABs, Letters to Industry, Frequently Asked Questions, and *Current Issues* outlines. Second, the SEC staff may provide interpretive implementation guidance to select audiences in speeches and in other public remarks, some of which are published on the SEC website. Finally, the SEC staff provides interpretive implementation guidance to individual registrants in two ways – in its comments to registrants during filing reviews and in response to registrant requests that the SEC staff not object to a specific interpretive implementation issue in what is commonly referred to in the private sector as the “pre-clearance” process. Although guidance provided to individual registrants is based on each registrant’s specific facts and circumstances, other registrants may independently conclude that it is appropriate to apply the guidance to their own facts and circumstances. Their advisors and auditors often encourage them to do so.

We noted several areas where the SEC staff could improve the consistency of the interpretive implementation guidance it provides in its filing reviews. Although the SEC staff has procedures in place for registrants to request reconsideration of SEC staff conclusions in comment letters or pre-clearance matters, registrants may choose not to avail themselves of these processes because they may be concerned about missing market opportunities to raise capital, the potential risk of re-opening other issues to reconsideration or their fear of possible retribution (misguided or not).

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<sup>121</sup> See, e.g., comment letters from the Center for Audit Quality (November 20, 2007); the Council of Institutional Investors (March 31, 2008); Ernst & Young LLP (March 31, 2008); Financial Executives International – Committee on Corporate Reporting (April 4, 2008); Financial Executives International – Committees on Small and Mid-Sized Public Companies and on Finance & Information Technology (March 31, 2008); and KPMG LLP (March 31, 2008).

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## Discussion

While the Commission has the ultimate authority to establish accounting standards for public companies, it has historically indicated, and in 2003 reaffirmed as a result of the Sarbanes-Oxley Act of 2002, that pronouncements of the FASB are recognized as “generally accepted” for purposes of the federal securities laws. However, the distinction between the roles of the Commission and the FASB can become blurred when it comes to SEC staff actions that may be perceived as providing broadly applicable interpretive implementation guidance. To the extent issues arise in SEC staff filing reviews or in the pre-clearance process that may indicate a need to consider interpreting, revising, or adding to U.S. GAAP, we believe it is appropriate for the SEC staff to refer those matters to the FASB for its consideration, such as through the proposed FRF.

We believe that the SEC staff should generally refrain from issuing interpretive implementation guidance that changes the application of U.S. GAAP because the SEC staff does not usually solicit public comment before issuing such guidance. We recognize there are times when it would nevertheless be necessary and appropriate for the SEC staff to issue broadly applicable interpretive implementation guidance, such as when a critical, time-sensitive need exists and the FASB has not had the opportunity to deliberate the matter. However, we believe the SEC staff should inform, if practical, the FASB Chairman before issuing broadly applicable interpretive implementation guidance, such as what is provided in SABs, Letters to Industry, and Frequently Asked Questions.

With regard to SEC staff comments to individual registrants in the filing review and the pre-clearance processes, financial reporting participants may misconstrue registrant-specific accounting outcomes as quasi-authoritative and apply these outcomes to similar fact patterns of other registrants. The SEC staff’s efforts to increase the transparency of its filing review process through the posting of comment and response letters may inadvertently increase this practice. We support the SEC staff’s public statements that its comments to an individual registrant are based on that registrant’s facts and circumstances and that one registrant should not necessarily change its accounting because it becomes aware of another comment letter, unless that registrant concludes, on its own, that it is appropriate to do so. The SEC staff should re-emphasize that its comment letter and pre-clearance processes are registrant-specific and take steps necessary to improve the transparency of the staff’s processes.

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We understand that the SEC staff has recently implemented or plans to implement various changes designed to increase the consistency of SEC staff comments and outcomes of the filing review process. In addition, we understand that the SEC staff is developing procedures to improve the consistency of the interpretive implementation guidance it provides in its speeches and other public remarks by supplementing the existing practice of reviews of such remarks by SEC senior staff members from various Divisions and Offices. These reviews help ensure that SEC staff speeches are not used to

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informally communicate broadly applicable interpretive implementation guidance. Rather, speeches should be used to highlight authoritative interpretive implementation guidance that has already been issued or U.S. GAAP compliance issues observed during the filing review and comment process that are clearly indicative of trends. We understand that the Commission plans to establish a disclosure standards function within the Division of Corporation Finance to monitor the consistency of SEC staff comments and review outcomes over time. We understand that the SEC staff is also in the process of consolidating all interpretive implementation guidance and other information intended for accountants into a single location on the SEC website. In an effort to increase registrant awareness of available reconsideration processes, we understand that this enhanced web page will include a recently-released, detailed description of the Division of Corporation Finance review and comment process that identifies the appropriate SEC staff members to contact when seeking reconsideration of SEC staff comments or views.<sup>122</sup> Although we cannot tell if this will diminish concerns about using these reconsideration processes, we support the SEC staff's efforts to improve transparency in this regard.

Although these planned improvements will take time to achieve their intended goals, we support these efforts and recommend that the Commission undertake an internal periodic review of their effectiveness. Specifically, we recommend that the Commission direct the appropriate SEC senior staff members to continually monitor whether these revised internal staff procedures are successful.

## **VII. Design of Standards**

***Recommendation 2.6:*** *The SEC should recommend that the FASB build upon recent improvements made to the design of accounting standards as part of its Understandability initiative – primarily by increasing the use of clearly-stated objectives, outcomes, and principles, and emphasizing the importance in financial reporting of being responsive to investor and other user needs for clarity, transparency, and comparability, while seeking to capture the economic substance of transactions to the extent feasible.*

### **Background**

Certain accounting standards do not clearly articulate the objectives, outcomes, and principles upon which they are based, because they are sometimes obscured by dense language, detailed rules, and exceptions. This can create uncertainty in the application of U.S. GAAP and produce confusing results for investors. Further, the proliferation of detailed rules fosters accounting-motivated structured transactions, as rules cannot cover

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<sup>122</sup> See <http://www.sec.gov/divisions/corpfin/cffilingreview.htm>.

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all outcomes. As discussed in chapter 1, standards that have exceptions to general principles and bright lines are vulnerable to manipulation by those seeking to avoid accounting for the substance of transactions using structured transactions that are designed to achieve a particular accounting result. This ultimately hurts investors and other users, because it reduces comparability and the usefulness of the resulting financial information. Therefore, a move toward the use of more objectives, outcomes, and principles in accounting standards may ultimately improve the quality of the financial reporting upon which investors and other users rely.

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## Discussion

We recognize that the question of how to design accounting standards going forward is a critical aspect of the standards-setting process and is at the center of a decade-long principles-based versus rules-based accounting standards debate. There has been much discussion in the marketplace on this topic and there are differing views. The SEC has been a frequent participant in the debate and has long been supportive of objectives-oriented standards.<sup>123</sup> Rather than engage in such a debate, we prefer to think of the design of accounting standards in terms of the characteristics they should possess. There are many publications on this topic written by well-known commenters from the FASB, the IASB, the SEC, accounting firms, academia, and elsewhere. The most recent example is an omnibus of this collective thinking published by the CEOs of the World's Six Largest Audit Networks.<sup>124</sup> Their paper attempts to outline what optimal accounting standards should look like in the future and proposes a framework the standards-setter should refer to over time to ensure that these characteristics are consistently optimized.

The FASB has made recent improvements in how it writes and structures accounting standards as part of its Understandability initiative and the Codification project. We support the increased use of clearly-stated objectives, outcomes, and principles in accounting standards to build upon these improvements. We believe the highest goal for accounting standards in the future is that they should faithfully represent the economics of transactions and be responsive to investor and other user needs for clarity, transparency, and comparability. Standards that meet these criteria, when applied in good faith in a financial reporting system that employs our other recommendations, will

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<sup>123</sup> For example, the SEC issued *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter* (April 2003), which included numerous recommendations for the FAF and FASB to consider, including greater use of principles-based accounting standards whenever reasonable to do so. The SEC staff also issued *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (July 2003), which further lauded the benefits of objectives-oriented standards.

<sup>124</sup> CEOs of the World's Six Largest Audit Networks, *A Proposed Framework for Establishing Principles-Based Accounting Standards*, Global Public Policy Symposium (January 2008).

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foster enhanced comparability and help to increase investor confidence in financial reporting.

Although we support increased use of objectives, outcomes, and principles, the goal would not be to remove all rules. Rather, we agree with the notion that ideal accounting standards lie somewhere on the spectrum between principles-based and rules-based and that a framework may be helpful to consistently determine where on that spectrum new accounting standards should be written over time. This would assist the standards-setter in determining the volume of rules that may be necessary under certain circumstances. For example, if the standards-setter believes that there is only one way to reflect the economics of a transaction while promoting clarity, transparency, and comparability for investors and other users, it would be reasonable to provide prescriptive guidance in addition to objectives, outcomes, and principles.

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## CHAPTER 3: AUDIT PROCESS AND COMPLIANCE

### I. Introduction

In this chapter, we concentrate on the subjects of financial restatements, including the potential benefits from providing guidance with respect to the materiality<sup>125</sup> and correction of errors; and judgments related to accounting matters: specifically, whether guidance on the evaluation of judgments would enhance the quality of judgments and the willingness of others to respect judgments made.

### II. Financial Restatements

#### Background

##### *Likely Causes of Restatements*

The number of financial restatements<sup>126</sup> in the U.S. financial markets has been increasing significantly over recent years, reaching approximately 1,600 companies in 2006.<sup>127</sup> Although the number of restatements appears to have declined in 2007, the number is still quite high.<sup>128</sup> Restatements generally occur because errors that are determined to be material are found in financial statements previously provided to the public. Therefore, the increase in restatements appears to be due to an increase in the identification of errors that were determined to be material.

The increase in restatements has been attributed to various causes. These include: more rigorous interpretations of accounting and reporting standards by preparers, outside auditors, the SEC, and the PCAOB; the considerable amount of work done by companies to prepare for and improve internal controls in applying the provisions of section 404 of the Sarbanes-Oxley Act of 2002; and the existence of control weaknesses that companies

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<sup>125</sup> A fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

<sup>126</sup> For the purposes of this chapter, a restatement is the process of revising previously issued financial statements to reflect the correction of a material error in those financial statements. An amendment is the process of filing a document with revised financial statements with the SEC to replace a previously filed document. A restatement could occur without an amendment, such as when prior periods are revised when they are to be presented in a subsequent filing with the SEC.

<sup>127</sup> U.S. Government Accountability Office (GAO) study, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates* (March 2007), and Audit Analytics study, *2006 Financial Restatements A Six Year Comparison* (February 2007).

<sup>128</sup> Glass Lewis & Co. report, *The Tide is Turning* (January 15, 2008) indicates that approximately 1 out of every 11 public companies had a restatement during 2007.

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failed to identify or remediate. Some have also asserted that the increase in restatements is the result of an overly broad application of the concept of materiality and misinterpretations of the existing guidance regarding materiality in SAB 99, *Materiality* (as codified in SAB Topic 1M).<sup>129</sup> SAB Topic 1M was written primarily to address a specific issue, when seemingly small errors could be material due to qualitative factors. However, the guidance in SAB Topic 1M is often utilized in other materiality decisions. As a result of this broad application of SAB Topic 1M, errors may have been deemed to be material when an investor may not consider them to be important.

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When material errors occur, companies should restate their financial statements to correct errors that are important to current investors. Investors need accurate and comparable data, and restatement is the best means to achieve those goals when previously filed financial statements contain errors that are material to investors making current investment decisions.

Furthermore, we believe that public companies should focus on reducing errors in financial statements. In this regard, we believe that some of our recommendations in other chapters will be helpful in reducing the frequency of errors in financial statements. These include recommendations to reduce complexity, such as the recommendations to limit scope exceptions, alternative accounting policies and bright lines, and the recommendation to have the FASB complete and adopt a measurement framework discussed in chapter 1, recommendations to improve the standards-setting process and to delineate authoritative interpretive guidance discussed in chapter 2, the recommendation on judgment discussed in section III of this chapter, and the recommendation on XBRL discussed in chapter 4.

An important factor in reducing errors in financial reporting is the presence of an effective system of internal control over financial reporting. Efforts to improve company controls and audit quality in recent years should reduce errors, and there is evidence this is currently occurring.<sup>130</sup> We are fully supportive of the many benefits that have resulted from the implementation of section 404 of the Sarbanes-Oxley Act and the related standards issued by the SEC and the PCAOB. While internal control over financial reporting has been strengthened in recent years, there is evidence indicating that material weaknesses in internal control are often identified after a financial reporting problem has arisen, and perhaps only as a result of the event itself.<sup>131</sup> Financial reporting would

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<sup>129</sup> See, e.g., comment letters from the Bar Association of the City of New York (April 18, 2008) and John J. Huber, Latham and Watkins LLP (March 13, 2008).

<sup>130</sup> A Glass Lewis & Co. report, *The Tide is Turning* (January 15, 2008), shows that restatements in companies subject to section 404 of the Sarbanes Oxley Act have declined for two consecutive years.

<sup>131</sup> A Moody's Investors Service's report, *The Third Year of Section 404 Reporting on Internal Control, Controls Problems are decreasing, but reporting can be improved* (May 2007), an Audit Analytics report, *404 Dashboard, Year 3 Update* (December 2007) and a Glass Lewis & Co. report, *Restatements: Out of*

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clearly be improved if there was more timely identification of material weaknesses, and remediation of these weaknesses to prevent errors from occurring in the first place. Therefore, we encourage the SEC and the PCAOB to continue to stress the timely identification and correction of weaknesses, with appropriate emphasis on tone at the top and corporate governance as key factors that will lead to early identification and timely action, particularly as they relate to the potential for fraudulent financial reporting.

While reducing errors in financial reporting is the primary goal, it is also important to reduce the number of restatements that do not provide important information to investors making current investment decisions. Restatements can be costly for companies and auditors, may reduce confidence in reporting, and may create confusion that reduces the efficiency of investor analysis. This portion of this chapter describes our recommendations regarding: (1) additional guidance on the concept and application of materiality, and (2) the process for, and disclosure of, the correction of errors.

### ***Our Research***

We considered several publicly-available studies<sup>132</sup> on restatements. The restatement studies we have reviewed all indicate that the total number of restatements increased over the last decade, through they appear to have declined in 2007. The studies also indicate that there are many different types of errors that result in the need for restatements. Based on these studies, it appears to us that there may be restatements that may not be important to investors making current investment decisions.<sup>133</sup> We draw this conclusion in part based upon the lack of a statistically significant market reaction, particularly as the market reaction relates to certain types of restatements such as reclassifications and

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*Sight, Out of Mind* (May 30, 2008), all indicate that there is a very high percentage of material weaknesses that are first reported in connection with either a restatement of prior period financial statements or a material audit adjustment.

<sup>132</sup> Studies considered include the study commissioned by the Department of the Treasury: Susan Scholz, *The Changing Nature and Consequences of Public Company Financial Restatements 1997-2006* (April 2008); Marlene Plumlee and Teri Yohn, *An Analysis of the Underlying Causes of Restatements* (March 2008); two GAO studies, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates* (March 2007) and *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges* (October 2002); two Glass Lewis & Co. studies, *The Errors of Their Ways* (February 2007) and *Restatements: Out of Sight, Out of Mind* (May 30, 2008); and two Audit Analytics studies, *2006 Financial Restatements A Six Year Comparison* (February 2007) and *Financial Restatements and Market Reactions* (October 2007). We have also considered findings from the PCAOB's Office of Research and Analysis's (ORA) working paper, *Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era* (October 18, 2007), understanding that ORA's findings are preliminary in nature, as the study is still going through a peer review process.

<sup>133</sup> See, e.g., comment letter from Financial Executives International – Committee on Corporate Reporting (April 4, 2008).

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restatements affecting non-core expenses.<sup>134</sup> While there are limitations<sup>135</sup> to using market reaction as a proxy for materiality, other trends in these studies are not inconsistent with our conclusion – the trend toward restatements involving corrections of smaller amounts, including amounts in the cash flow statement, and the trend toward restatements in cases where there is no evidence of fraud or intentional wrongdoing. A recent study also indicated that restatements related to non-core expenses increased from approximately 20% of total restatements in 1997 to 39% in 2006, and that the sum of such restatements in 2005 and 2006 (1,086) is nearly equal to the sum over all the other eight years of the study (1,116).<sup>136</sup> Despite recent evidence that the number of restatements declined in 2007, we note that the total number of restatements is still significant. We, therefore, believe that supplementing existing guidance on determining whether an error is material and providing additional guidance on when a restatement is necessary would be beneficial in reducing the frequency of restatements that do not provide important information to investors making current investment decisions.

We have also considered input from equity and credit analysts and others about investors' views on materiality and how restatements are viewed in the marketplace.<sup>137</sup> Feedback we have received included:

- Bright lines are not really useful in making materiality judgments. Both qualitative and quantitative factors should be considered in determining if an error is material.
- Companies often provide the market with little financial data during the time between an announcement of the identification of errors in historical financial statements and the filing of restated financial statements. Limited information seriously undermines the quality of investor analysis, and sometimes triggers potential loan default conditions or potential delisting of the company's stock.
- The disclosure provided in connection with restatements is not consistently adequate to allow an investor to evaluate the likelihood of errors in the future. Notably,

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<sup>134</sup> Susan Scholz's study defines restatements related to non-core expenses as "Any restatement including correction of expense (or income) items that arise from accounting for non-operating or non-recurring activities." This definition includes restatements related to debt and equity instruments, derivatives, gain or loss recognition, inter-company investments, contingency and commitments, fixed and intangible asset valuation or impairment and income taxes.

<sup>135</sup> Examples of the limitations in using market reaction as a proxy for materiality include: (1) the difficulty of measuring market reaction because of the length of time between when the market becomes aware of a potential restatement and the ultimate resolution of the matter, (2) the impact on the market price of factors other than the restatement, and (3) the disclosure at the time of the restatement of other information, such as an earnings release, that may have an offsetting positive market reaction.

<sup>136</sup> These trends are addressed in Susan Scholz's study. Susan Scholz's study also indicates that the relative frequency of revenue-related restatements has declined from approximately 40% of total restatements in 1997 to approximately 11% of total restatements in 2007, with the caveat that the ending of the technology bubble (technology firms tend to disproportionately restate revenue) and the introduction of SEC Staff Accounting Bulletin No. 101 on revenue recognition would explain a decrease in revenue restatements.

<sup>137</sup> See, e.g., comment letters the CFA Institute Centre for Financial Market Integrity (March 31, 2008) and ITAC (December 13, 2007).

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disclosures often do not provide enough information about the nature and impact of the error, and the resulting actions the company is taking.

- Interim periods should be viewed as more than just a component of an annual financial statement for purposes of making materiality judgments.

### **Recommendations**

We believe that, in addressing a financial statement error, it is helpful to consider two sequential questions:

- 1) Was the error in the financial statement material to those financial statements when originally filed? and
- 2) How should a material error in previously issued financial statements be corrected?

We believe that framing the principles necessary to evaluate these questions would be helpful.<sup>138</sup> We also believe that in many circumstances investors could benefit from improvements in the nature and timeliness of disclosure in the period between identifying an error and filing restated financial statements.<sup>139</sup>

With this context, we recommend the following regarding the assessment of the materiality of errors to financial statements and the correction of financial statements for errors.<sup>140</sup>

***Recommendation 3.1: The FASB or the SEC, as appropriate, should supplement existing guidance to reinforce the following concepts:***

- *Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor*
- *Materiality should be judged based on how an error affects the total mix of information available to a reasonable investor, including through a consideration of qualitative and quantitative factors.*

***The FASB or the SEC, as appropriate, should also conduct both education sessions internally and outreach efforts to financial statement preparers and auditors to***

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<sup>138</sup> See, e.g., comment letters from PricewaterhouseCoopers LLP (March 31, 2008); Steven E. Bochner, Wilson Sonsini Goodrich & Rosati LLP (March 13, 2008); and the Bar Association of the City of New York (April 18, 2008).

<sup>139</sup> See, e.g., comment letters from the CFA Institute Centre for Financial Market Integrity (March 31, 2008) and Elizabeth F. Mooney, The Capital Group Companies (March 13, 2008).

<sup>140</sup> We recommend principles that we believe will be helpful in addressing financial statement errors. In recommending these principles, we have not determined if the principles are inconsistent with existing U.S. GAAP, such as SFAS No. 154, *Accounting Changes and Error Corrections*, or APB Opinion No. 28, *Interim Financial Reporting*. To the extent that the implementation of our recommendations would require a change to U.S. GAAP, the SEC should work with the FASB to revise U.S. GAAP.

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***raise awareness of these issues and to promote a more consistent application of the concept of materiality.***

The Supreme Court has established that “a fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available.”<sup>141</sup> We believe that those who judge the materiality of a financial statement error should make the decision based upon the interests, and the viewpoint, of a reasonable investor and based upon how that error impacts the total mix of information available to a reasonable investor. Preparers, audit committees, and auditors must “step into the shoes” of a reasonable investor when making these judgments. We believe that too many materiality judgments are being made in practice without full consideration of how a reasonable investor would evaluate the error. The total mix of information should be the main focus of a materiality judgment: while quantitative factors are quite important, qualitative factors are also relevant in analyzing the materiality of all errors. This is why bright lines or purely quantitative methods are not appropriate in determining the materiality of an error to annual financial statements.<sup>142</sup>

We believe that the current materiality guidance in SAB Topic 1M is appropriate in making most materiality judgments. We believe that, in current practice, however, this materiality guidance is being interpreted generally as being one-directional, that is, as providing that qualitative considerations can result only in a small error being considered material. This one-directional interpretation is not consistent with the standard established by the Supreme Court, which requires an assessment of the total mix of information available to the investor making an investment decision. We believe that, in evaluating the materiality of all errors, consideration should be given to both qualitative and quantitative factors that would be important to the reasonable investor, although we acknowledge that there will probably be more times when qualitative considerations will result in a small error being considered material than they will result in a large error being considered not to be material.<sup>143</sup> Therefore, we recommend that the existing materiality guidance be enhanced to clarify that the total mix of information available to investors should be the main focus of a materiality judgment and that qualitative factors are relevant in analyzing the materiality of all errors. We view this recommendation as a modest clarification of the existing guidance to conform practice to the standard

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<sup>141</sup> See supra note 125.

<sup>142</sup> See, e.g., comment letter from CALPERS (March 13, 2008).

<sup>143</sup> Some have argued that this view could result in a very large error affecting financial statement metrics meaningful to investors being deemed to be immaterial by virtue of qualitative factors. The Committee believes that the probability of management, after consultation with the company’s audit committee and independent auditors, reaching such a conclusion is remote. In such a remote instance, moreover, the company would be required to correct and disclose the error, as discussed in recommendation 3.2.

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established by the Supreme Court and not a major revision to the concepts and principles embodied in existing SEC staff guidance in SAB Topic 1M.

The following are examples of some of the qualitative factors, in addition to those set forth in SAB Topic 1M, which should be considered when evaluating the materiality of all errors. (Note that this is not an exhaustive list of factors, nor should this list be considered a “checklist” whereby the presence of any one of these items would make an error not material. Companies and their auditors should continue to look at the totality of all factors when making a materiality judgment):

- The error impacts metrics that do not drive investor conclusions or are not important to investor models
- The error is a one time item and does not alter investors’ perceptions of key trends affecting the company
- The error does not impact a business segment or other portion of the registrant's business that investors regard as driving valuation or risks.

Internal education and external outreach efforts can be instrumental in increasing the awareness of these concepts and ensuring more consistent application of materiality. Many of the issues with materiality in practice are caused by misunderstandings by preparers, auditors and regulators. Elimination of these misunderstandings would be a significant step toward reducing restatements that do not provide useful information to investors.<sup>144</sup>

***Recommendation 3.2: The FASB or the SEC, as appropriate, should issue guidance on how to correct an error consistent with the principles outlined below:***

- ***Companies should be required to promptly correct all errors, excluding clearly insignificant errors, and should make appropriate disclosure about prior period errors that are corrected in the current period. Companies should not have the option to defer correction of errors until future financial statements.***
- ***Prior period financial statements should only be restated for errors that are material to those prior periods.***
- ***The determination of how to correct a material error should be based on the needs of investors making current investment decisions. For example, a material error that is not important to a current investment decision would not require restatement of the financial statements in which the error occurred, but would need to be promptly corrected and prominently disclosed in the current period.***
- ***There may be no need for the filing of amendments to previously filed annual or interim reports to reflect restated financial statements, if the next annual or***

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<sup>144</sup> See, e.g., comment letter from the Center for Audit Quality (March 31, 2008).

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*interim period report is being filed in the near future and that report will contain all of the relevant information.*

- *Restatements of interim periods do not necessarily need to result in a restatement of an annual period.*
- *Corrections of large errors in previously issued financial statements should always be disclosed in the filing in a prominent manner, even if the error is determined not to be material.*<sup>145</sup>
- *To limit the likelihood of “stealth restatements,” the SEC should revise the instructions to Form 8-K to state clearly that the form needs to be filed for all determinations of non-reliance on prior financial statements.*

Companies should be required to correct promptly all errors, excluding clearly insignificant errors, and make appropriate disclosures about the correction of prior period errors; they should not have the option to defer correction of errors until future financial statements. By correcting small errors when they are identified, a company substantially reduces the likelihood that the continuation of the error over a period of time will result in the total amount of the error becoming material to a company’s financial statements and requiring correction at that time. Notwithstanding the foregoing, immaterial errors discovered shortly before the issuance of the financial statements may not need to be corrected until the next annual or interim period being reported upon when earlier correction is impracticable.<sup>146</sup>

The current guidance that is detailed in SAB 108 (as codified in SAB Topic 1N) may result in the restatement of prior annual periods for immaterial errors occurring in those periods because the cumulative effect of these prior period errors would be material to the current annual period, if the prior period errors were corrected in the current annual period. We believe that prior annual period financial statements should not be restated for errors that are immaterial to the prior annual period. Instead of the approach specified in Topic 1N, we believe that, where errors are not material to the prior annual periods in which they occurred but would be material if corrected in the current annual period, the error could be corrected in the current annual period with appropriate disclosure at the time the current annual period financial statements are filed with the SEC. Regardless of

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<sup>145</sup> Whatever manner is chosen by a company for prominent disclosure of the correction of an accounting error, such disclosure of corrected errors should be included in the notes to the company’s financial statements (delineated as such to the extent feasible) in order to preserve the record from period to period.

<sup>146</sup> We understand that sometimes there may be immaterial differences between a preparer’s estimate of an amount and the independent auditor’s estimate of an amount that exist when financial statements are issued. These differences might or might not be errors, and may require additional work to determine the nature and actual amount of the error. This additional work is not necessary for the preparer or the auditor to agree to release the financial statements. Due care should be taken in developing any guidance in this area to provide an exception for these legitimate differences of opinion, and to ensure that any requirement to correct all “errors” would not result in unnecessary work for preparers or auditors.

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how these errors are corrected,<sup>147</sup> we believe that there should be prominent disclosure showing the impact on the financial statements of correcting errors from prior financial statements.

More generally, we believe that the determination of how errors should be corrected should be based on the needs of investors making current investment decisions. This determination should take into account the facts and circumstances of each error. For example, a prior period error that was material to that prior period, but that does not affect the annual financial statements or financial information included within a company's most recent filing with the SEC, may not need to be corrected through an amendment to prior period filings if the financial statements that contain the error are determined not to be important to investors making current investment decisions. Such errors would be corrected in the period in which they are discovered with appropriate disclosure about the error and the periods impacted. This approach would provide investors making current investment decisions with more timely financial reports and avoid the costs to investors of delaying prompt disclosure of current financial information in order for a company to correct multiple prior filings.

For material errors that are discovered within a very short time period prior to a company's next regularly scheduled reporting date, it may be appropriate in certain instances to restate prior financial statements, as relevant, but to report this restatement in the next filing with appropriate disclosure of the error and its impact on prior periods, instead of amending previous filings with the SEC. The SEC should consider inclusion of this option in the overall guidance on how to correct errors after evaluating the likelihood of abuse.<sup>148</sup> As part of a response, the SEC might confirm our view that while no amendment would be required of a report filed with the SEC, we believe that a company would still be required to file a current report on Form 8-K under Item 4.02, "Non Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review," in order to alert investors to the existence of a material error.

Assuming that there is an error in an interim period within an annual period for which financial statements have previously been filed with the SEC, the following guidance should be utilized:

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<sup>147</sup> We are focused on the principle that prior periods should not be restated for errors that are not material to those periods. Correction in the current period of errors that are not material to prior periods could be accomplished through an adjustment to equity or to current period income with either appropriate disclosure or separate classification of the adjustment. These approaches might potentially require an amendment to U.S. GAAP. We believe that there are merits in these approaches and that the FASB and the SEC, as appropriate, should carefully weigh these approaches before determining the actual approach to utilize.

<sup>148</sup> See, e.g., comment letter from the Consumer Federation of America (January 16, 2008).

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- If the error is not material to either the previously issued interim period financial statements or to the previously issued annual period financial statements, the previously issued financial statements should not be restated.
- If the prior period error is determined to be material only to the previously issued interim period financial statements, but not the previously issued annual period financial statements, then only the previously issued interim period financial statements should be restated (i.e., the annual period financial statements that are already filed should not be restated and the annual report on Form 10-K should not be amended). However, there should be appropriate disclosure in the company's next annual report on Form 10-K to explain the discrepancy in the results for the interim periods during the previous annual period on an aggregate basis and the reported results for that annual period.

We believe that investors should be informed about all large errors when they are corrected. Even if management, after consultation with the company's audit committee and independent auditors, concludes that a large error is not material because of qualitative factors, there should be appropriate disclosure about the error, including the magnitude of the error, the periods impacted by the error, and the factors that led management to conclude the error was not material.<sup>149</sup>

We believe that the issuance by the FASB or the SEC, as appropriate, of guidance on how to correct and disclose errors in previously issued financial statements will provide to investors higher quality and more timely information (e.g., less delay occasioned by the need for restatement of prior period financial statements for errors that are not material and for errors that have no relevance to investors making current investment decisions) and reduce the burdens on companies related to the preparation of amended reports. Since our recommendation would require prompt correction and appropriate disclosure about all errors, excluding clearly insignificant errors, it would enhance transparency of accounting errors and help to eliminate the phenomenon of so-called "stealth restatements" – when an error impacts past financial statements without disclosure of such error in current financial filings. Stealth restatements would also be reduced if, as the GAO recommended to the SEC, the SEC amends the instructions to the Form 8-K and other relevant periodic filings to clearly state that an Item 4.02 disclosure on Form 8-K is required for all determinations of non-reliance on previously issued financial statements irrespective of whether such information has been disclosed in a periodic report or elsewhere.<sup>150</sup>

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<sup>149</sup> See, e.g., comment letter from BDO Seidman, LLP (March 31, 2008).

<sup>150</sup> GAO study, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates* (March 2007).

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***Recommendation 3.3: The FASB or the SEC, as appropriate, should issue guidance on disclosure of financial and other reliable information during the period during which the impact of a financial reporting error is being evaluated or the restatement is being prepared, about the need for the restatement and about the restatement itself to improve the adequacy of this disclosure based on the needs of investors.***

Typically, the restatement process involves three primary reporting stages:

1. The initial notification to the SEC and investors that a financial reporting error is being evaluated or a material error has been identified resulting in a conclusion that the financial statements previously filed with the SEC can no longer be relied upon
2. The “dark period” or the period between the initial notification to the SEC and the time restated financial statements are filed with the SEC and
3. The filing of restated financial statements with the SEC.

We believe that investors are adversely affected when companies are silent during stage 2, or the “dark period.” This silence creates significant uncertainty regarding the size and nature of the effects on the company of the error or the issues leading to the restatement.<sup>151</sup> This uncertainty often results in decreases in the company’s stock price. In addition, delays in filing reports or restated financial statements may create default conditions in loan covenants; these delays also may adversely affect the company’s liquidity. We understand that, in the current legal environment, companies are often unwilling to provide disclosure of uncertain information. However, we believe that when companies are evaluating errors or going through the restatement process, they should be encouraged to continue to provide any reasonably reliable financial information that they can, accompanied by appropriate explanations of ways in which the information could be affected by a restatement. Consequently, regulators should evaluate a company’s disclosures during the “dark period,” taking into account the difficulties of generating reasonably reliable information before a restatement is completed.

We believe that the current disclosure surrounding a restatement is often not adequate to allow investors to evaluate the company’s operations and the likelihood that such errors could occur in the future. Specifically, we believe that all companies that are evaluating errors or preparing restated financial statements should be required to disclose information related to: (1) the nature of the error, (2) the impact of the error, and (3) management’s response to the error, to the extent known, during all three stages of the restatement process. Some suggestions of disclosures that would be made by companies include the following:

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<sup>151</sup> See, e.g., comment letters from ITAC (December 13, 2007) and CALPERS (March 13, 2008).

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#### **Nature of error**

- Description of the error
- Periods affected and under review
- Material items in each of the financial statements subject to the error and pending restatement
- For each financial statement line item, the amount of the error or range of potential error
- Identity of business units/locations/segments/subsidiaries affected

#### **Impact of error**

- Updated analysis on trends affecting the business if the error impacted key trends
- Loan covenant violations, ability to pay dividends, and other effects on liquidity or access to capital resources
- Other areas, such as loss of material customers or suppliers

#### **Management Response**

- Nature of the control weakness that led to the restatement and corrective actions, if any, taken by the company to prevent the error from occurring in the future
- Actions taken in response to covenant violations, loss of access to capital markets, loss of customers, and other consequences of the restatement

If there are material developments related to the restatement, companies should update this disclosure on a periodic basis during the restatement process, particularly when quarterly or annual reports are required to be filed, and provide full and complete disclosure within the filing with the SEC that includes the restated financial statements.

***Recommendation 3.4: The FASB or the SEC, as appropriate, should develop and issue guidance on applying materiality to errors identified in prior interim periods and how to correct these errors. This guidance should reflect the following principles:***

- ***Materiality in interim period financial statements must be assessed based on the perspective of the reasonable investor***
- ***When there is a material error in an interim period, the guidance on how to correct that error should be consistent with the principles outlined in recommendation 3.2.***

Based on prior restatement studies, approximately one-third of all restatements involved only interim periods. Authoritative accounting guidance on assessing materiality with respect to interim periods is currently limited to paragraph 29 of APB Opinion No. 28,

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*Interim Financial Reporting*.<sup>152</sup> Differences in interpretation of this paragraph have resulted in variations in practice that have increased the complexity of financial reporting. This increased complexity impacts preparers and auditors, who struggle with determining how to evaluate the materiality of an error to an interim period, and also impacts investors, who can be confused by the inconsistency between how companies evaluate and report errors.<sup>153</sup>

We believe that guidance as to how to evaluate errors related to interim periods would be beneficial to preparers, auditors and investors. We have observed that a large part of the dialogue about interim materiality has focused on whether an interim period should be viewed as a discrete period or an integral part of an annual period. Consistent with the view expressed at the outset of this section, we believe that the interim materiality dialogue could be greatly simplified if that dialogue were refocused to address two sequential questions:

- 1) What principles should be considered in determining the materiality of an error in interim period financial statements? and
- 2) How should errors in previously issued interim financial statements be corrected?

We believe that additional guidance on these questions, which are extensions of the basic principles outlined in recommendations 3.1 and 3.2 above, would provide useful guidance in assessing and correcting interim period errors.

We believe that the determination of whether an interim period error is material should be made based on the perspective of a reasonable investor,<sup>154</sup> not whether an interim period is a discrete period, an integral part of an annual period, or some combination of both. An interim period is part of a larger mix of information available to a reasonable investor.<sup>155</sup> As one example, a reasonable investor would use interim financial statements to assess the sustainability of a company's operations and cash flows so that an error that did impact the sustainability of a company's operations and cash flows may very well be material. However, if an error in interim financial statements did not impact the sustainability of a company's operations and cash flows, the interim period error may very well not be material given the total mix of information available.

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<sup>152</sup> Paragraph 29 of APB Opinion No. 28, *Interim Financial Reporting*, states the following:

In determining materiality for the purpose of reporting the cumulative effect of an accounting change or correction of an error, amounts should be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings. Changes that are material with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings should be separately disclosed in the interim period.

<sup>153</sup> See, e.g., comment letters from Ernst and Young LLP (March 31, 2008) and John J. Huber, Latham and Watkins LLP (March 13, 2008).

<sup>154</sup> See, e.g., comment letter from CALPERS (March 13, 2008).

<sup>155</sup> Both qualitative and quantitative factors are relevant to any determination of materiality.

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We believe that applying the principles set forth above would reduce restatements by providing a company the ability to correct in the current period immaterial errors in previously issued financial statements and as a practical matter obviate the need to debate whether the interim period is a discrete period, an integral part of an annual period, or some combination of both.

We also note that these principles will provide a mechanism, other than restatement, to correct through the current period a particular error that has often been at the center of the interim materiality debate – a newly-discovered error that has accumulated over one or more annual or interim periods, but was not material to any of those prior periods.

### **III. Judgment**

#### **Background**

##### *Overview*

Judgment is not new to the areas of accounting, auditing, or securities regulation – the criteria for making and evaluating judgment have been a topic of discussion for many years. The recent increased focus on judgment, however, comes from several different developments, including changes in the regulation of auditors, more use of fair value estimates, and a focus on more principles-based standards. Investors are likely to benefit from more emphasis on principles-based standards, since rules-based standards (as discussed in chapters 1 and 2) may provide a method, such as through exceptions and bright-line tests, to avoid the accounting objectives underlying the standards. In other words, without the exercise of judgment, rules in the form of bright lines may result in a false consistency – that is, ostensibly uniform accounting for differing fact patterns. If properly implemented, “principles-based” standards should improve the information provided to investors while reducing investor concerns about “financial engineering” by companies using the rules to avoid accounting for the substance of a transaction. While preparers appear supportive of a move to less prescriptive guidance, they have expressed concern regarding the perception that current practice by regulators in evaluating judgments does not provide an environment in which such judgments may be generally respected.<sup>156</sup> This, in turn, can lead to repeated calls for more rules, so that the standards can be comfortably implemented.

Many regulators also appear to encourage a system in which preparers can use their judgment to determine the most appropriate accounting and disclosure for a particular

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<sup>156</sup> See, e.g., comment letters from Financial Executives International – Committee on Corporate Reporting (April 4, 2008) and Deloitte and Touche LLP (March 31, 2008).

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transaction. Regulators assert that they do respect judgments, but also express concerns that some companies may attempt to inappropriately defend certain errors as “reasonable judgments.” Identifying how regulators evaluate judgments may provide an environment that promotes the use of judgment and encourages consistent evaluation practices among regulators.

### ***Goals of Potential Guidance on Judgments***

The following are several issues that any potential guidance related to judgments may help address:

- a. Investors’ lack of confidence in the use of judgment – Guidance on judgments may provide investors with greater comfort that there is an acceptable rigor that companies follow in exercising reasonable judgment.
- b. Preparers’ concern regarding whether reasonable judgments are respected – In the current environment, preparers may be afraid to exercise judgment for fear of having their judgments overruled, after the fact, by regulators.
- c. Lack of agreement in principle on the criteria for evaluating judgments – Identification of the criteria for evaluating reasonable judgments, including the appropriate role of hindsight in the evaluation, may not be clearly defined, which may lead to increased uncertainty.
- d. Concern over increased use of principles-based standards – Companies may be less comfortable with their ability to implement more “principles-based” standards if they are concerned about how reasonable judgments are reached and how they will be assessed.

### ***Categories of Judgments that are Made in Preparing Financial Statements***

There are many categories of accounting and auditing judgments that are made in preparing financial statements, and any guidance should encompass all of these categories, if practicable. Some of the categories of accounting judgment are as follows:

#### **1. Selection of accounting standard**

In many cases, the selection of the appropriate accounting standard under U.S. GAAP is not a highly complex judgment (e.g., leases would be accounted for using lease accounting standards and pensions would be accounted for using pension accounting standards). However, there are cases in which the selection of the appropriate accounting standard can be highly complex.

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For example, the standards on accounting for derivatives contain a definition of a derivative and provide scope exceptions that limit the applicability of the standard to certain types of derivatives. To evaluate how to account for a contract that has at least some characteristics of a derivative, one would first have to determine if the contract met the definition of a derivative in the accounting standard and then determine if the contract would meet any of the scope exceptions that limited the applicability of the standard. Depending on the nature and terms of the contract, this could be a complex judgment to make, and one on which experienced accounting professionals can have legitimate differing, yet acceptable, opinions.

2. Implementation of an accounting standard

After the correct accounting standard is identified, there are judgments to be made during its implementation. Examples of implementation judgments include determining if a hedge is effective, if a lease is an operating or a capital lease, and what inputs and methodology should be utilized in a fair value calculation. Implementation judgments can be assisted by implementation guidance issued by standards-setters, regulators, and other bodies; however, this guidance could increase the complexity of selecting the correct accounting standard, as demonstrated by the guidance issued on accounting for derivatives.

Further, many accounting standards use wording such as “substantially all” or “generally.” The use of such qualifying language can increase the amount of judgment required to implement an accounting standard. In addition, some standards may have potentially conflicting statements.

3. Lack of applicable accounting standards

There are some transactions that may not readily fit into a particular accounting standard. Dealing with these “gray” areas of U.S. GAAP is typically highly complex and requires a great deal of judgment and accounting expertise. In particular, many of these judgments use analogies from existing standards that require a careful consideration of the facts and circumstances involved in the judgment.

4. Financial statement presentation

The appropriate method to present, classify and disclose the accounting for a transaction in a financial statement can be highly subjective and can require a great deal of judgment.

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5. Estimating the actual amount to record

Even when there is little debate as to which accounting standard to apply to a transaction, there can be significant judgments that need to be made in estimating the actual amount to record.

For example, opinions on the appropriate standard to account for loan losses or to measure impairments of assets typically do not differ. However, the assumptions and methodology used by management to actually determine the allowance for loan losses or to determine an impairment of an asset can be a highly judgmental area.

6. Evaluating the sufficiency of evidence

Not only must one make a judgment about how to account for a transaction, but the sufficiency of the evidence used to support the conclusion must also be evaluated. In practice, this is typically one of the most subjective and difficult judgments to make.

Examples include determining if there is sufficient evidence to estimate sales returns or to support the collectability of a loan.

***Levels of Judgment***

There are many levels of judgment that occur related to accounting matters. Preparers must make initial judgments about uncertain accounting issues; the preparer's judgment may then be evaluated or challenged by auditors, investors, regulators, legal claimants, and even others, such as the media. Guidance should not suggest that those who evaluate a judgment must re-perform the judgment according to the guidance. Instead, guidance should provide clarity to those who would make a judgment on factors that those who would evaluate the judgment would consider while making that evaluation.

***Hindsight***

The use of hindsight to evaluate a judgment where the relevant facts were not available at the time of the initial release of the financial statements (including interim financial statements) is not appropriate.<sup>157</sup> Determining at what point the relevant facts were known to management, *or should have been known*,<sup>158</sup> can be difficult, particularly for regulators who are often evaluating these circumstances after substantial time has passed.

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<sup>157</sup> See, e.g., comment letter from Deloitte and Touche LLP (March 31, 2008).

<sup>158</sup> We believe that those making a judgment should be expected to exercise due care in gathering all of the relevant facts prior to making the judgment.

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Therefore, hindsight should be based only on the facts reasonably available at the time the relevant annual or interim financial statements were issued.

### *Form of Potential Guidance*

We believe that there are many different ways that potential guidance on judgment could be provided. To be successful, however, we believe that guidance on judgment should not eliminate debate, nor be inflexible or mechanical in application. Rather, the guidance should encourage preparers to organize their analysis and focus preparers and others on areas to be addressed, thereby improving the quality of the judgment and likelihood that regulators will accept the judgment. Any guidance issued should be designed to stimulate a rigorous, thoughtful and deliberate process rather than a checklist-based approach for making and evaluating judgments.<sup>159</sup>

A preferred way to accomplish the goals we set forth earlier as well as to guard against the potential that such guidance would develop into a checklist-based approach is for the SEC to articulate its approach to evaluating judgments. As discussed earlier in this report, one of the major concerns surrounding the use of judgment is the possibility of a regulator “second-guessing” the reasonableness of a judgment after the fact. We believe that a primary cause of this concern is a lack of clarity and transparency into the approach the SEC uses to evaluate the reasonableness of judgments. The SEC has articulated its policies in the past with success. Examples of previous articulations of policy by the SEC include the “Seaboard” report (October 23, 2001) relating to the impact of a company’s cooperation on a potential SEC enforcement case and the SEC’s framework for assessing the appropriateness of corporate penalties (January 4, 2006). We believe that a statement of policy<sup>160</sup> could implement the goals we have articulated and therefore recommend that the SEC and the PCAOB issue statements of policy describing how they evaluate the reasonableness of accounting and auditing judgments.

### *The Nature and Limitations of U.S. GAAP*

Some have suggested that a factor for evaluating judgments be a requirement to reflect the “economic substance” of a transaction. For example, there is general agreement that accounting should follow the substance and not just the form of a transaction or event. Many believe that this fundamental principle should be extended to require that all U.S. GAAP judgments reflect economic substance. However, reasonable people disagree on what economic substance actually is, and many would conclude that significant parts of current U.S. GAAP do not require and do not purport to measure economic substance (e.g., accounting for leases, pensions, certain financial instruments and internally

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<sup>159</sup> See, e.g., comment letter from CALPERS (March 13, 2008).

<sup>160</sup> See, e.g., comment letter from CALPERS (March 13, 2008).

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developed intangible assets are often cited as examples of items reported in accordance with U.S. GAAP that would not meet many reasonable definitions of economic substance).

Similarly, some have suggested that a factor for evaluating judgments be a requirement to reflect the “high road” – to use the most preferable principle in all instances.

Unfortunately, today a preparer is free to select from a variety of acceptable methods allowed by U.S. GAAP (e.g., costing inventory, measuring depreciation, and electing to apply hedge accounting are just some of the many varied methods allowed by U.S. GAAP) without any qualitative standard required in the selection process. In fact, a preferable method is required to be followed only when a change in accounting principle is made, and a less preferable alternative is fully acceptable absent such a change.

We agree that qualitative standards for U.S. GAAP such as these would be desirable and we encourage regulators and standards-setters to move financial reporting in this direction. However, such standards are not always present in financial reporting today, and we cannot recommend the articulation of such standards in an SEC statement of policy without anticipating a fundamental long-term revision of U.S. GAAP – a change that would be beyond our purview and one that would not be doable in the near- or intermediate-term. Our recommendation that the SEC issue a statement of policy relating to its evaluation of judgments could and we believe would enhance adherence to U.S. GAAP, but such a statement of policy cannot be expected to correct inherent weaknesses in the standards to which judgment would be applied.

### **Recommendation**

Broadly speaking, preparers and auditors should abide by the principles that underlie accounting standards. To support this goal, we recommend the following:

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***Recommendation 3.5: The SEC should issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments and include factors that it considers when making this evaluation. The PCAOB should also adopt a similar approach with respect to auditing judgments.***

***The statement of policy applicable to accounting-related judgments should address the choice and application of accounting principles, as well as estimates and evidence related to the application of an accounting principle. We believe that a statement of policy that is consistent with the principles outlined in this recommendation to cover judgments made by auditors based on the application of PCAOB auditing standards would be beneficial to auditors. Therefore, we recommend that the PCAOB develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards. The***

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***PCAOB's statement of policy should acknowledge that the PCAOB would look to the SEC's statement of policy to the extent the PCAOB would be evaluating the appropriateness of accounting judgments as part of an auditor's compliance with PCAOB auditing standards.***

***We believe that it would be useful if the SEC also set forth in the statement of policy factors that it looks to when evaluating the reasonableness of preparers' accounting judgments.***

### ***The Concept of Judgment in Accounting Matters***

Judgment, with respect to accounting matters, should be exercised by a person or persons who have the appropriate level of knowledge, experience, and objectivity to form an opinion based on the relevant facts and circumstances within the context provided by applicable accounting standards. Judgments could differ between knowledgeable, experienced, and objective persons. Such differences between reasonable judgments do not, in themselves, suggest that one judgment is wrong and the other is correct.<sup>161</sup> Therefore, those who evaluate judgments should evaluate the reasonableness of the judgment, and should not base their evaluation on whether the judgment is different from the opinion that would have been reached by the evaluator.

We have listed below various factors that we believe preparers should consider when making accounting judgments. The SEC may want to take these factors into account in developing its statement of policy. We also believe that a suggestion by the SEC that preparers should carefully consider these factors when making accounting judgments would be beneficial in not only increasing the quality of judgments, but also in helping the SEC and preparers more efficiently resolve potential differences during the SEC's review of a preparer's filings. However, the mere consideration by a preparer of these factors in a SEC statement of policy would not prevent a regulator from asking appropriate questions about the accounting judgments made by the preparer or asking companies to correct unreasonable judgments. In fact, there is no guarantee that the preparer's consideration of the SEC's suggested factors articulated in a statement of policy would result in a reasonable judgment being reached. Rather, the statement of

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<sup>161</sup> Some have asserted that the acceptance of reasonable judgments may result in a lack of comparability that is inconsistent with the principles expressed in chapter 1. However, regardless of the level of detail in accounting guidance, judgment will always be required. This is especially true in the context of newly-adopted standards, which cannot contemplate all implementation questions prior to issuance. As discussed in chapter 2, we believe that the FASB should closely examine if a new accounting standard is being interpreted inconsistently and take appropriate action, if needed. To promote consistency, we also include factors 8 and 9 in our suggestions for an SEC statement of policy on the evaluation of the reasonableness of accounting judgments.

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policy should be designed to encourage preparers to organize their analysis and focus preparers and others on areas that are likely to be addressed in the SEC's review, thereby improving the quality of the judgment and likelihood that regulators will accept the judgment. We encourage the SEC to seek to accept a range of alternative reasonable judgments when preparers make good faith attempts to reach a reasonable judgment. A preparer's failure to follow the SEC's suggested factors in its statement of policy, however, would not imply that the judgment is unreasonable.

We would expect that, in the evaluation of judgments made using the factors that are cited below, the focus would be on significant matters requiring judgment that could have a material effect on the financial statements taken as a whole. We recognize that the facts and circumstances of each judgment may indicate that certain factors are more important than others. These factors would have a greater influence in an evaluation of the reasonableness of a judgment made by a preparer.

### ***Factors to Consider when Evaluating the Reasonableness of a Judgment***

We believe that accounting judgments should be based on a critical and reasoned evaluation made in good faith and in a rigorous, thoughtful, and deliberate manner. We believe that preparers should have appropriate controls in place to ensure adequate consideration of all relevant factors. Factors applicable to the making of an accounting judgment include the following:

1. The preparer's analysis of the transaction, including the substance and business purpose of the transaction
2. The material facts reasonably available at the time that the financial statements are issued
3. The preparer's review and analysis of relevant literature, including the relevant underlying principles
4. The preparer's analysis of alternative views or estimates, including pros and cons for reasonable alternatives
5. The preparer's rationale for the choice selected, including reasons for the alternative or estimate selected and linkage of the rationale to investors' information needs and the judgments of competent external parties
6. Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated
7. The level of input from people with an appropriate level of professional expertise<sup>162</sup>
8. The preparer's consideration of known diversity in practice regarding the alternatives or estimates<sup>163</sup>

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<sup>162</sup> In many cases, input from professional experts would include consultation with a preparer's independent auditors or other competent external parties, such as valuation specialists, actuaries or counsel.

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9. The preparer's consistency of application of alternatives or estimates to similar transactions
10. The appropriateness and reliability of the assumptions and data used
11. The adequacy of the amount of time and effort spent to consider the judgment.

When considering these factors, it would be expected that the amount of documentation, disclosure, input from professional experts, and level of effort in making a judgment would vary based on the complexity, nature (routine versus non-routine), and materiality of a transaction or issue requiring judgment.

Material issues or transactions should be disclosed appropriately. We note that existing disclosure requirements should be sufficient to generate transparent disclosure that enables an investor to understand the transaction and assumptions that were critical to the judgment. The SEC has provided in the past, and should continue to consider providing, additional guidance on existing disclosure requirements to encourage more transparent disclosure. In addition, when evaluating the reasonableness of a judgment, regulators should take into account the disclosure relevant to the judgment.<sup>164</sup>

### ***Documentation***

The alternatives considered and the conclusions reached should be documented contemporaneously. This will ensure that the evaluation of the judgment is based on the same facts that were reasonably available at the time the judgment was made. The lack of contemporaneous documentation may not mean that a judgment was incorrect, but would complicate an explanation of the nature and propriety of a judgment made at the time of the release of the financial statements.

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<sup>163</sup> If there is little diversity in practice, it would be significantly harder to select a different alternative.

<sup>164</sup> Existing disclosure requirements include the guidance on critical accounting estimates in the SEC's *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, SEC Release No. 33-8350 (December 19, 2003) (2003 MD&A Interpretive Release); the SEC's *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, SEC Release No. 33-8040 (December 12, 2001); and Accounting Principles Board Opinion No. 22, *Disclosure of Accounting Policies*. We also encourage the SEC to continue to remind preparers of ways to improve the transparency of disclosure, such as through statements like the Sample Letter sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements) issued by the Division of Corporation Finance in March 2008.

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## CHAPTER 4: DELIVERING FINANCIAL INFORMATION

### I. Introduction

We evaluated the information needs of investors, methods by which financial information is provided to investors, and means to improve delivery of financial information to all market constituencies. In evaluating the information needs of investors, we recognized that the information needs of different types of investors are not always the same. We agreed that information provision must be accomplished in a manner that is efficient, reliable, and cost-effective for each of the relevant investor groups and will not significantly increase burdens on reporting companies.

In this chapter, we focus our efforts on financial information provided by reporting companies in their periodic and current reports under the Securities Exchange Act of 1934 (“Exchange Act”) and other ongoing disclosures provided by reporting companies to investors and the market.<sup>165</sup> We believe that our recommendations will enhance ongoing reporting that will enable investors to better understand reporting companies.

Based on the above, we analyzed a number of ways to improve the delivery of financial information to investors and the market. These are:

- Tagging of financial information (XBRL or interactive data)
- Improving corporate website use
- Disclosures of key performance indicators (KPIs) and other metrics to enhance business reporting
- Improved quarterly press release disclosures and timing
- Use of executive summaries as an integral part of Exchange Act periodic reports

We received a number of comment letters and heard oral statements from 7 persons regarding these topics.<sup>166</sup>

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<sup>165</sup> We determined that we would not address information delivery in registered offerings under the Securities Act of 1933 for two primary reasons. First, the SEC already has addressed information delivery in registered securities offerings when it adopted new communication rules in 2005 for registered offerings by issuers other than registered investment companies. Second, we view information delivery relating to ongoing company reporting by public companies as the area needing greater focus.

<sup>166</sup> See, e.g., comment letters from ADVENTRX Pharmaceuticals, Inc. (March 14, 2008); American Accounting Association (April 30, 2008); Bar Association of the City of New York (April 18, 2008); BDO Seidman, LLP (March 31, 2008); Business Wire (February 4, 2008); Center for Audit Quality (March 31, 2008); CFA Institute Centre for Financial Market Integrity (March 31, 2008); EDGAR Online, Inc. (February 7, 2008); Enhanced Business Reporting Consortium (October 24, 2007 and March 31, 2008); Ernst & Young LLP (March 31, 2008); Financial Executives International – Committee on Corporate Reporting (April 4, 2008); FirstEnergy Corp. (March 31, 2008); Fitch Ratings, Inc. (April 2, 2008); Institute of Public Auditors in Germany (March 26, 2008); KPMG LLP (March 31, 2008); Ohio Society of CPAs (March 31, 2008); PricewaterhouseCoopers LLP (March 31, 2008); PR Newswire (September 21, 2007); and Steven E. Bochner, Wilson Sonsini Goodrich & Rosati (March 13, 2008). Also see, e.g.,

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## **II. Tagging of Financial Information (Interactive Data)**

Our recommendations increase the certainty that interactive data will be a significant part of the reporting landscape so that preparers, investors, auditors, software developers, and regulators make the needed investment in interactive data.

Based on the considerations discussed below, we have the following recommendations:

***Recommendation 4.1: The SEC should, over the long-term, mandate the filing of interactive data-tagged financial statements after the satisfaction of certain preconditions relating to: (1) successful XBRL U.S. GAAP Taxonomy testing, (2) the capacity of reporting companies to file interactive data-tagged financial statements using the new XBRL U.S. GAAP Taxonomy on the SEC's EDGAR system, and (3) the ability of the EDGAR system to provide an accurately rendered version of all such tagged information. The SEC should phase-in interactive data-tagged financial statements as follows:***

- ***The largest 500 domestic public reporting companies based on unaffiliated market capitalization (public float) should be required to furnish to the SEC, as is the case in the voluntary program today, a document prepared separately from the reporting companies' financial statements that are filed as part of their periodic Exchange Act reports. This document would contain the following:***
  - ***Interactive data-tagged face of the financial statements***<sup>167</sup>
  - ***Block-tagged footnotes to the financial statements.***<sup>168</sup>
- ***Domestic large accelerated filers (as defined in SEC rules, which would include the initial 500 domestic public reporting companies) should be added to the category of companies, beginning one year after the start of the first phase, required to furnish interactive data-tagged financial statements to the SEC.***

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testimony from Steven E. Bochner, Wilson Sonsini Goodrich & Rosati (March 14, 2008); Jeff M. Bodner, Intel Corporation (March 14, 2008); Mark Bolgiano, XBRL US (March 14, 2008); Randy G. Fletchall, Ernst & Young LLP (March 14, 2008); Gregory P. Hanson, ADVENTRX Pharmaceuticals (March 14, 2008); Christopher Montano, Gridstone Research (March 14, 2008); and John Turner, CoreFiling (March 14, 2008).

<sup>167</sup> To allow this first phase, the SEC EDGAR system must permit submissions using the new XBRL U.S. GAAP Taxonomy.

<sup>168</sup> We understand that tagging beyond the face of the financial statements and block-tagging of footnotes, such as granular tagging of footnotes and non-financial data, may require significant effort and would involve a significant number of tags. ▼

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*Once the preconditions noted above have been satisfied and the second phase-in period has been implemented, the SEC should evaluate whether and when to move from furnishing to the SEC interactive data-tagged financial statements to the official filing of such financial statements with the SEC for the domestic large accelerated filers, as well as the inclusion of all other reporting companies, as part of a company's Exchange Act periodic reports.<sup>169</sup>*

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## **Background**

### ***Description of Interactive Data***

XBRL is an international information format standard designed to help investors and analysts find, understand, and compare financial and non-financial information by making this information machine-readable. It enables companies to better control how their financial or non-financial information is presented and disseminated and to reduce reporting costs by integrating their operating data with their financial reporting disclosure. XBRL or interactive data is a computer language which uses standardized XML (eXtensible Markup Language) technology and permits the automation of what are now largely manual steps for access, validation, analysis, and reporting of disclosure. For example, an investor or analyst who wants to compare the sales of all pharmaceutical companies will be able to use software applications to take the interactive data-tagged information, extract the sales numbers and download them directly to a spreadsheet.

Interactive data uses standardized definitions of terms, like a dictionary. The standardized terms are then arranged in a logical structure called a taxonomy. A U.S. GAAP financial statement itself, in that its underlying details are summarized in the line items of a balance sheet or income statement, is a kind of taxonomy. There are taxonomies for different kinds of businesses. For example, the banking industry sector taxonomy differs from that of a software industry sector company.

### ***Status of Interactive Data-Tagged Financial Statements in SEC Reports***

The SEC adopted a voluntary pilot program for the use of interactive data tagging in which participants submit voluntarily supplemental tagged financial information using the interactive data format as exhibits to specified EDGAR filings.<sup>170</sup> Voluntary pilot participants may use existing standard XBRL taxonomies. Over four dozen companies

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<sup>169</sup> A dissenting vote on developed proposal 4.1 was cast by Peter Wallison in February 2008.

<sup>170</sup> The SEC's voluntary interactive data rules specify the form, content, and format of interactive data submissions, description of interactive data, timing of interactive data submissions, and use of taxonomies. For example, the rules require the tagged data to be described either as "unaudited" or, for quarterly financial statements, "unreviewed."

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are participating in the pilot program and have agreed to voluntarily submit their annual, quarterly and other reports with interactive data for a period of one year. The SEC recently expanded the voluntary filing program to include mutual funds which will file using a risk and return taxonomy developed by the Investment Company Institute.

On May 30, 2008, the SEC proposed amendments requiring certain companies to provide to the SEC financial statements in interactive data format using XBRL.<sup>171</sup> The proposed rules would apply to domestic and foreign companies using U.S. GAAP and, eventually, to foreign private issuers using IFRS as issued by the IASB.<sup>172</sup>

On April 28, 2008, XBRL-US released its U.S. GAAP Taxonomy and preparer's guide. The XBRL U.S. GAAP Taxonomy includes tags for a company's financial statements and notes.

The SEC has stated that it will use the initial financial statements prepared using the new XBRL U.S. GAAP Taxonomy to help it further update its EDGAR system so that it will be able to "seamlessly accept and render the filings." We understand that the SEC's EDGAR system is being modified to accept and render financial statements with interactive data tags based on the newly-developed XBRL U.S. GAAP Taxonomy.

#### *Time and Costs Involved in Interactive Data-Tagging*

We understand that while the XBRL U.S. GAAP Taxonomy has a significant number of individual tags or elements, it contains all of the terms or concepts commonly used in financial statements prepared in accordance with U.S. GAAP. We understand that reporting companies would use only a limited number of tags or elements. For example, one large voluntary filer uses approximately 192 tags (it tags its notes as blocks rather than at a granular level) to tag its Form 10-Q. We understand that there may be the need for customized "extensions" if the XBRL U.S. GAAP Taxonomy does not include a tag for the particular item in the company's financial statements. Because the XBRL U.S. GAAP Taxonomy tracks U.S. GAAP, we believe that there likely will be less need for customized extension elements.

The type of information that is tagged also is relevant to understanding interactive data-tagged financial statements. Companies participating in the voluntary program have been tagging the face of their financial statements using existing taxonomies and software. As

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<sup>171</sup> See, *Interactive Data to Improve Financial Reporting*, SEC Release No. 33-8924 (May 30, 2008) ("Interactive Data Release").

<sup>172</sup> Under the proposal, interactive data would be required with a company's annual and quarterly reports, transition reports, and Securities Act registration statements, and on its corporate website, if it maintains one. The disclosure in interactive data format would supplement, but not replace or change, disclosure using the traditional electronic filing formats in ASCII or HTML. See Interactive Data Release.

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to the notes to the financial statements, additional effort may be involved. While the notes to the financial statements may easily be tagged as a block of text, unlike preparation of notes to the financial statements in a paper-based format, tagging the individual information in each note will involve additional tags and, therefore, more work than block-tagging the text.<sup>173</sup> The SEC's proposed rules would provide that the footnote disclosure be tagged using four different levels of detail.<sup>174</sup>

We understand that the software industry has been engaged in developing tagging and rendering (turning the interactive data-tagged information into a human readable format) software for interactive data-tagged financial statements.<sup>175</sup> Companies generally use two methods to tag their financial statements using interactive data tagging. The first method, called a "bolt-on" approach, involves developing the interactive data reports after the filed financial statements are developed – a process known as "mapping." Companies also may use interactive data as part of an integrated approach to financial reporting. In an integrated approach, companies incorporate interactive data into their internal company financial systems which allows financial reports to be created from the interactive data-tagged financial systems, without first preparing such financial statements in "human readable format." Interactive data-tagging using a "bolt-on" approach may involve somewhat more effort than using an integrated approach. Currently, there is software that allows companies to interactive data-tag their financial statements using the "bolt-on" approach.<sup>176</sup> At this time it is unknown how many companies have begun integrating interactive data-tagging into their internal financial reporting systems and, therefore, it is not clear when a significant number of companies would move from a "bolt-on" to an integrated approach to interactive data-tagging of their financial statements.

Certain preparers participating in the SEC's voluntary program have indicated that the initial number of hours it took to tag the face of their financial statements using existing

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<sup>173</sup> See Interactive Data Release. Also see, e.g., comment letters from the CFA Institute Centre for Financial Market Integrity (March 31, 2008); BDO Seidman, LLP (March 31, 2008); and the Center for Audit Quality (March 31, 2008).

<sup>174</sup> This level of detail would be:

- (i) each complete footnote tagged as a single block of text (which would be the only footnote tagging in the filer's first year of interactive data reporting);
- (ii) each significant accounting policy within the significant accounting policies footnote tagged as a single block of text;
- (iii) each table within each footnote tagged as a separate block of text; and
- (iv) within each footnote, each amount (i.e., monetary value, percentage, and number) separately tagged and each narrative disclosure required to be disclosed by U.S. GAAP (or IFRS issued by the IASB, if applicable), and Commission regulations separately tagged.

See Interactive Data Release.

<sup>175</sup> See, e.g., testimony from John Turner (March 14, 2008).

<sup>176</sup> Using the "bolt-on" method, companies can prepare their financial statements (including notes) in a number of formats, such as Adobe (pdf), Word, and HTML.

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standard taxonomies (not the new XBRL U.S. GAAP Taxonomy) and a “bolt-on” approach ranged from 80-100 hours and that the number of hours dropped significantly for subsequent reports (due to the lack of a need to replicate the tagging process for most items).<sup>177</sup> For preparers also tagging the notes to their financial statements using a “block” tag, the number of hours increased slightly. The costs to tag the face of the financial statements using standardized software were not significant. Additional time and cost was spent by at least one preparer to validate the tags that were used. In these cases, there was no auditor involvement in the process.<sup>178</sup>

### ***Smaller Public Company Reactions to Interactive Data-Tagging***

Smaller public company representatives recognize the benefits that interactive data offers their companies over the long-term, but are concerned about initial implementation costs, which could be alleviated with the development of improved tagging and verification software. The representatives strongly support a phase-in approach in which such smaller public companies would be included at the end, once larger public companies had worked through any significant implementation issues, including use of company resources involved in tagging and verification of interactive data tags.<sup>179</sup>

### ***Potential Benefits of Interactive Data***

We see a number of potential benefits of interactive data for reporting companies and investors relating to financial and non-financial information. First, interactive data-tagging could benefit reporting companies by permitting improved communications with analysts and investors. Released corporate data could be instantaneously and immediately usable by analysts in their models without the need for them to wait for third party aggregators or staff to input the data into their own format. There would be a reduction in search costs. Further, such reduced search costs could potentially increase coverage of companies, especially mid-size and smaller companies, by sell-side and buy-side analysts, and at both major brokerage and independent research firms. Interactive data-tagging also would likely improve the quality of data<sup>180</sup> and the ability of a company to control the presentation of its financial information. The elimination or reduction of

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<sup>177</sup> For example, one S&P 500 company participating in the voluntary pilot spent 80 hours learning the tagging tool, understanding SEC requirements, creating extensions for tags, and creating a process for ongoing tagging and future submissions.

<sup>178</sup> See, e.g., comment letter from EDGAR Online (February 7, 2008). For a discussion of cost estimates relating to the SEC’s proposed interactive data rules, including based on information received from participants in the voluntary program, see the Interactive Data Release.

<sup>179</sup> See, e.g., comment letters from ADVENTRX Pharmaceuticals, Inc. (March 14, 2008) and Steven E. Bochner, Wilson Sonsini Goodrich & Rosati (March 13, 2008).

<sup>180</sup> Although XBRL is frequently called “interactive data,” the use of the term “data” should not be deemed to imply numerical data alone. XBRL also is useful for the tagging of narrative information.

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the manual input would likely reduce error rates in reporting and inputting of corporate data by aggregators.<sup>181</sup>

Second, interactive data has the potential to improve the integration of company operating and reporting data. Using interactive data, operating data can be accessed in the internal enterprise applications where it is regularly stored, and thus will be used for financial reporting purposes without the necessity of downloading to paper or manual search. The same electronically accessible data can be used for other purposes beyond those of financial statements, including tax, industrial filings, audit, benchmarking, performance reporting, internal management, and sustainability. We believe that the full economic benefits of interactive data will most likely come when companies incorporate interactive data into their internal reporting, instead of using it as a “bolt-on” after their financial reports are prepared.

Finally, interactive data-tagged financial statements can provide a number of benefits to investors, including both retail investors and the “model builder/research analyst.” Investors can benefit from, among other things, a reduced cost of locating and inputting data into analytical frameworks, elimination of manual input thereby reducing the likelihood of input error by an investor or data aggregator, reduced investor dependence on proprietary and inconsistent data sources, increased likelihood of more investors utilizing primary data sources, and reduced cost of and improved company comparisons. The interactive data-tagged financial statements should enable investors and experienced analysts at research organizations to spend more time analyzing data than data gathering.<sup>182</sup>

We recognize, however, that notwithstanding the potential benefits, many company officers may not understand how interactive data works or what improvements it could bring to both their financial reporting and their costs of reporting. In addition, there currently is limited acceptance of interactive data due, in part, to companies needing greater certainty that interactive data will be adopted before they will expend the necessary resources to understand it and its benefits. Companies may have other concerns about potential start-up costs in adopting interactive data, including the purchase of software and personnel resources for data input and training. Further, analysts and software developers generally are unaware or uninformed about interactive data.<sup>183</sup>

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<sup>181</sup> See, e.g., comment letters from ADVENTRX Pharmaceuticals, Inc. (March 14, 2008) and the CFA Institute Centre for Financial Market Integrity (March 31, 2008).

<sup>182</sup> See, e.g., comment letter from the CFA Institute Centre for Financial Market Integrity (March 31, 2008).

<sup>183</sup> See, e.g., testimony from John Turner (March 14, 2008). Also see, e.g., comment letters from the CFA Institute Centre for Financial Market Integrity (March 31, 2008) and Financial Executives International – Committee on Corporate Reporting (April 4, 2008).

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## *Implementation of Interactive Data-Tagging of Financial Statements*

We believe that the SEC should, over the long-term, require all public reporting companies (preparing their financial statements using U.S. GAAP) to tag the financial statements (including footnotes) they are required to file with the SEC as part of their Exchange Act reports using interactive data. We believe that an implementation roadmap from the SEC is needed to encourage the involved parties to move beyond a wait-and-see approach and commit resources toward the necessary development of software. That software would tag financial information and enable the viewing and reading of the interactive data-tagged information, the use of interactive data-tagged data by investors such as analysts and investors, and the integration of interactive data by companies. We believe that full implementation of mandated interactive data-tagged financial statements will require a phase-in over a period of time, as discussed below, to enable preparers and investors to understand interactive data, to permit successful use of the new XBRL U.S. GAAP Taxonomy, and to enable the further development of tagging and rendering software. We believe that such a phase-in should be sensitive to the concerns of smaller public companies regarding mandated interactive data-tagged financial statements. We note that the SEC proposals regarding interactive data contain components of our developed proposals from our Progress Report, but have expanded beyond our developed proposals in a number of regards.<sup>184</sup> At the Committee meeting on March 14, 2008 held in San Francisco, the Committee received oral and written input from market participants regarding the interactive data developed proposals. We are not modifying our recommendations from those developed proposals.

We believe that mandatory implementation of interactive data will involve a number of steps leading to the ultimate goal of requiring public reporting companies to tag their financial statements using interactive data.

Full mandatory implementation may not be possible until all the following preconditions are met:

- Taxonomy development
  - The release and availability of the XBRL U.S. GAAP Taxonomy and preparer guide.

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<sup>184</sup> For example, the SEC proposed rules would require certain reporting companies to file a new exhibit containing financial statements and any applicable financial statement schedules in interactive data format beginning with fiscal periods ending on or after December 15, 2008. The proposed rules also would apply to reporting companies using U.S. GAAP and the interactive data requirements would phase-in for all such reporting companies over the next two years. See the Interactive Data Proposing Release.

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Status: XBRL U.S. announced in May 2008 that it had finalized the U.S. GAAP taxonomies and preparer guide.

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- Voluntary filers have successfully used the XBRL U.S. GAAP Taxonomy and preparer guide for a period of time.
- Ability of SEC EDGAR to “seamlessly” accept interactive data submissions using the new XBRL U.S. GAAP Taxonomy and other interactive data-tagged data, and provide an accurate rendered version of all such tagged information.

Status: The SEC is currently accepting financial statements prepared using the new XBRL U.S. GAAP Taxonomy, and those statements can be rendered seamlessly on an SEC viewer. Improvements are being made continuously to both ends of the process, so that EDGAR will be able to “seamlessly accept and render the filings.”

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We believe that, to achieve the desired acceptance of interactive data, now that the XBRL U.S. GAAP Taxonomy precondition has been satisfied, on an interim basis interactive data-tagged financial statements should be required to be implemented on a phase-in basis as follows:

- The largest 500 domestic public reporting companies based on unaffiliated market capitalization (public float) should be required to furnish to the SEC, as is the case in the voluntary program today, a document prepared separately from the reporting companies’ financial statements that are filed as part of their periodic Exchange Act reports. This document would contain the following:
  - Interactive data-tagged face of the financial statements<sup>185</sup>
  - Block-tagged footnotes to the financial statements.<sup>186</sup>
- Domestic large accelerated filers (as defined in SEC rules, which would include the initial 500 domestic public reporting companies) should be added to the category of companies, beginning one year after the start of the first phase, required to furnish interactive data-tagged financial statements to the SEC.

We believe that a phase-in would provide businesses, financial planners, software developers, and investors with the impetus to move forward in building systems based on interactive data. For example, in connection with the mandatory implementation of

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<sup>185</sup> To allow this first phase, the SEC EDGAR system must permit submissions using the new XBRL U.S. GAAP Taxonomy.

<sup>186</sup> We understand that tagging beyond the face of the financial statements and block-tagging of footnotes, such as granular tagging of footnotes and non-financial data, may require significant effort and would involve a significant number of tags. See footnote 174 above regarding the SEC’s proposed rules regarding the tagging of footnotes. For cost information regarding footnote tagging, see the Interactive Data Release.

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interactive data, we are aware that, if tagging were mandated for companies, they may use a “bolt-on” solution in-house or use a service provider in the early stages before moving to a broader integrated interactive data approach. This “bolt-on” approach, for many, could be used as a means to begin to climb the learning curve in a cheap, easily managed manner. In this regard, we believe that companies should have the capacity to compare interactive data-tagged and rendered financial statements to avoid errors and the SEC should take steps to assist in that regard. We believe that the SEC should encourage or contract for the development of free software to compare rendered and filed statements.<sup>187</sup>

During the phase-in period, the SEC and PCAOB should seek input from companies, investors, and other market participants as to the experience of such persons in preparing and using interactive data-tagged financial statements using the XBRL U.S. GAAP Taxonomy, and related costs. The SEC should consider conducting or contracting for a study of the rate of errors by companies in using the appropriate interactive data tags in comparison to the financial statement items, which should be done only after filers use the final uniform Taxonomy and preparer guidance to tag their financial statements.<sup>188</sup>

As mentioned above, under the phase-in approach, the interactive data-tagged financial statements would still be considered furnished to and not filed with the SEC. As part of the mandatory implementation, we believe that, as is the case in the voluntary program, the SEC should make clear what liability provisions the interactive data-tagged financial statements would be subject to under the federal securities laws.<sup>189</sup>

Finally, at the end of the phase-in period described above, and as promptly as practicable after all the preconditions to full implementation discussed above are met, the SEC should evaluate the results from the phase-in period to determine whether and when to move from furnishing to the SEC to the official filing of interactive data-tagged financial statements with the SEC by domestic large accelerated filers, as well as whether and

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<sup>187</sup> See, e.g., comment letter from the CFA Institute Centre for Financial Market Integrity (March 31, 2008).

<sup>188</sup> See, e.g., comment letters from the Bar Association of the City of New York (April 18, 2008) and the Center for Audit Quality (March 31, 2008).

<sup>189</sup> See, e.g., comment letters from the Center for Audit Quality (March 31, 2008) and the Ohio Society of CPAs (March 31, 2008). The SEC’s proposed rules address liability issues relating to the interactive data files. For example, under the proposed rules, data in the interactive data file submitted to the SEC would be subject to the federal securities laws in a manner similar to that of the voluntary program and, as a result, would be deemed not filed for purposes of specified liability provisions; excluded from the officer certification requirements under Exchange Act Rules 13a-14 and 15d-14; and protected from liability for failure to comply with the proposed tagging and related requirements if the interactive data file either: (i) met the requirements; or (ii) failed to meet those requirements, but the failure occurred despite the issuer’s good faith and reasonable effort, and the issuer corrected the failure as soon as reasonably practicable after becoming aware of it. See Interactive Data Release.

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when to include all other reporting companies, as part of a company's Exchange Act periodic reports.<sup>190</sup>

We note that there have been developments in software for interactive data, such as the use of "microformat," that would assist companies in tagging their financial statements. In a "microformat" system, some interactive data material and human readable financial statements can be integrated into the same document. As with certain other rendering software, a reader can see the relevant interactive data material by rolling a cursor over the human readable text and visa versa.

### II.C. Assurance

An important issue related to tagging public company financial statements using interactive data involves whether assurance should be provided by a third party. We understand that among the primary benefits of providing independent assurance of interactive data documents is that financial statement investors could quickly build confidence in interactive data and increase their use of such data. One primary reason for not obtaining such independent assurance of interactive data documents is the concern that the cost and time incurred to obtain such assurance may significantly outweigh the benefits to preparers and investors.<sup>191</sup> We note that the SEC's proposed rules would not require the involvement of "third parties such as auditors or consultants in the creation of the interactive data provided as an exhibit to a filer's periodic reports or registration statements, including assurance."<sup>192</sup>

As to assurance, we understand that questions arise as to whether assurance should be provided as to matters such as:

1. The appropriate use of the proper XBRL U.S. GAAP Taxonomy and accurate tagging of financial statements
2. The reasonableness of any company extensions to the XBRL U.S. GAAP Taxonomy
3. The compliance of the interactive data-tagged document (also called the "instance document") with SEC content and format requirements
4. The separate performance of validation checks over footings and inter-checks (for example, if inventory is reported more than once throughout the document, determine if amounts reported are consistent) of the interactive data instance document

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<sup>190</sup> We do note that the SEC's proposed rules would subject all reporting issuers using U.S. GAAP to the interactive data requirements.

<sup>191</sup> See, e.g., comment letters from the Center for Audit Quality (March 31, 2008); Financial Executives International – Committee on Corporate Reporting (April 4, 2008); and Steven E. Bochner, Wilson Sonsini Goodrich & Rosati (March 13, 2008).

<sup>192</sup> See the Interactive Data Release.

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5. Whether the information in the interactive data instance document is the same as the information in the official filed financial statements (applicable under a “bolt-on” state).

The concept of obtaining assurance on the correct tags and matching the interactive data rendered documents to the filed statements is predicated on the belief that the incremental monetary and human resource costs to provide the assurance will be very small. Reviewing the tags the first time will involve significant effort, but subsequent reviews may be limited to new or changed tags. Moreover, the costs and benefits of assurance reviews may differ depending on whether companies are using the “bolt-on” rather than the integrated tagging approach. Therefore, we believe that it is appropriate to study the assurance process during the phase-in period to assess the actual costs and benefits of assurance that might be provided on the interactive data-tagged financial statements.

The type, timing, and extent of assurance, if any, on a company’s interactive data-tagged financial statements and other tagged information required to be furnished to the SEC should take into account the needs of investors, and other market participants, along with the costs to reporting companies. Until a group of reporting companies has been required to furnish to the SEC interactive data-tagged financial statements and notes using the new XBRL U.S. GAAP Taxonomy for a period of time that will allow investors and other market participants to evaluate the reliability of such interactive data-tagged financial statements and notes, it is premature to make concrete suggestions regarding assurance.

Accordingly, our recommendation does not include any assurance proposal. During the interim phase-in period discussed above, the SEC and PCAOB should seek input from companies, investors, and other market participants as to the type, timing, and extent of desired or needed assurance, if any. This input should include the experience of such persons in preparing and using interactive data-tagged financial statements using the newly-developed XBRL U.S. GAAP Taxonomy, and related costs. Additionally, after public companies are required to tag their financial statements using interactive data, whether in accordance with our recommendations or otherwise, the SEC should consider initiating a voluntary pilot program in which companies obtain assurance on their interactive data-tagged financial statements (whether using a “bolt-on” or integrated approach) in order to evaluate fully potential costs and benefits associated with such effort.

### **III. Improved Corporate Website Use**

***Recommendation 4.2: The SEC should issue a new comprehensive interpretive release regarding the use of corporate websites for disclosures of corporate information, which addresses issues such as liability for information presented in a summary format, treatment of hyperlinked information from within or outside a company’s website, treatment of non-GAAP financial disclosures and GAAP***

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*reconciliations, and clarification of the public availability of information disclosed on a reporting company's website.*

*Industry participants, including investors, should coordinate among themselves to develop uniform best practices on uses of corporate websites for delivering corporate information to investors and the market.*

### **Background**

The SEC has issued a series of interpretive releases and rules addressing the use of electronic media to deliver or transmit information under the federal securities laws. The SEC issued its last comprehensive interpretive release on the use of electronic media, including corporate websites, in 2000. Since 2000, significant technological advances have increased both the market's demand for more timely corporate disclosure and the ability of investors to capture, process, and disseminate this information. Recognizing this, the SEC has adopted a large number of rules that mandate, permit, or require disclosure of the use of corporate websites to provide important corporate information and developments.<sup>193</sup> The SEC has voted to publish an interpretive release to provide guidance regarding the use of company websites under the Securities Exchange Act of 1934 and the antifraud provisions of the federal securities laws.

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### **Discussion**

We examined the integral role that technology and corporate websites play in informing the markets and investors about important corporate information and developments, including website disclosure presentations that are under development by software vendors. A valuable element of many of such website presentations is that they present the most important general information about a company on the opening page, with embedded links that enable the reader to drill down to more detail by clicking on the links. In this way, viewers can follow a path into, and thereby obtain increasingly greater details about, the financial statements, a company's strategy and products, its management and corporate governance, and its many other areas in which investors and others may have an interest. See appendix H for screen shots from a presentation made to us by Microsoft Corporation (Microsoft) about their plans for an innovative presentation of investor-related information on their corporate website.

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<sup>193</sup> See, e.g., comment letters from the Bar Association of the City of New York (April 18, 2008); Business Wire (February 4, 2008); the CFA Institute Centre for Financial Market Integrity (March 31, 2008); Financial Executives International – Committee on Corporate Reporting (April 4, 2008); and PR Newswire (September 21, 2008).

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Improving the use of corporate websites can enable shareholders and investors to gather information about a company that is at a level they believe is satisfactory for their purposes, without requiring them to wade through large amounts of written material that may provide a level of detail beyond their particular needs.

Corporate websites offer reporting companies a cost-effective, efficient method to provide information to investors and the market. Encouraging reporting companies to increase their use of their websites, including developing a tiered approach to deliver such corporate information on their websites, would benefit investors of all types, retail and institutional. Enhanced corporate website usage could decrease the complexity of information presentation (such as through the use of summaries with hyperlinks to more detailed information and discussion) and would enhance its accessibility. In addition, through coordination by industry participants, uniform best practices on uses of corporate websites could be developed.<sup>194</sup> Of course, the increased use of corporate websites is not intended to affect the valuable role that newswires and other news vehicles play in disseminating important company information to investors and the public.

We have been informed that there are continuing concerns about the treatment of website disclosures under the federal securities laws that some have argued may be impeding greater use of corporate websites. These concerns include liability for information presented in a summary format, the treatment of hyperlinked information from within or outside a company's website, the disclosure of non-GAAP financial measures and required reconciliations to GAAP, and the need for clarification of the public availability of information disclosed on a reporting company's website.<sup>195</sup> Consequently, we believe that the SEC should issue a new comprehensive interpretive release regarding the use of corporate websites for disclosures of corporate information. We believe that SEC guidance would encourage further creative use of corporate websites by reporting companies to provide information, including website disclosure formats following industry developed best practice guidelines. We are pleased that the SEC has taken our recommendation and will provide such additional guidance.

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#### **IV. Disclosures of KPIs and Other Metrics to Enhance Business Reporting**

***Recommendation 4.3: The SEC should encourage private sector initiatives targeted at best practice development of company use of key performance indicators (KPIs) in their business reports. The SEC should encourage private sector dialogue, involving preparers, investors (including analysts), and other interested industry participants, such as consortia that have long supported KPI-like concepts,***

<sup>194</sup> See, e.g., comment letters from the Enhanced Business Reporting Consortium (March 31, 2008); the CFA Institute Centre for Financial Market Integrity (March 31, 2008); and Financial Executives International – Committee on Corporate Reporting (April 4, 2008).

<sup>195</sup> See, e.g., comment letter from the Center for Audit Quality (Mar. 31, 2008).

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*to generate understandable, consistent, relevant, and comparable KPIs on relevant activity and, as appropriate, industry-specific, bases. The SEC also should encourage companies to provide, explain, and consistently disclose period-to-period company-specific KPIs. The SEC should consider reiterating and expanding its interpretive guidance regarding disclosures of KPIs in MD&A and other company disclosures.*

### **Background**

Enhanced business reporting and key performance indicators (KPIs) are disclosures about the aspects of a company's business that provide significant insight into the sources of its value. The Enhanced Business Reporting Consortium<sup>196</sup> has stated that the value drivers for a business "can be measured numerically through KPIs or may be qualitative factors such as business opportunities, risks, strategies and plans—all of which permit assessment of the quality, sustainability and variability of its cash flows and earnings."<sup>197</sup> KPIs can be non-financial measures and also can include supplemental non-GAAP financial reporting disclosures that proponents have stated can improve disclosures by public companies. KPIs are leading indicators of financial results and intangible assets that are not necessarily included in a company's balance sheet and can provide more transparency and understanding about the company to investors. Proponents of the use of KPIs note that they are important because they inform judgments about a company's future cash flows – and form the basis for a company's stock price. Managers and boards of directors of companies use KPIs to monitor performance of companies and of management. Market participants and the SEC have identified KPIs as important supplements to GAAP-defined financial measures.

We understand that investment professionals concur that investors are very interested in non-financial information as a way to better understand the businesses in which they invest.<sup>198</sup> They recognize that financial reports provide an accounting of past events and a current view of the financial condition of the company. The financials are viewed as an end of process result delivered as a combination of market conditions and company business strategies, processes and execution. The financials are, by their nature, not necessarily forward-looking indicators. Of interest to many investors from a business reporting standpoint is information regarding the fundamental drivers of the business and metrics used to give evidence as to how the business is being managed in the

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<sup>196</sup> The Enhanced Business Reporting Consortium was founded by the AICPA, Grant Thornton LLP, Microsoft, and PricewaterhouseCoopers LLP in 2005 upon the recommendation of the AICPA Special Committee on Enhanced Business Reporting. The Enhanced Business Reporting Consortium is an independent, market-driven non-profit collaboration focused on improving the quality, integrity and transparency of information used for decision-making in a cost-effective, time efficient manner.

<sup>197</sup> See, e.g., comment letter from the Enhanced Business Reporting Consortium (March 31, 2008).

<sup>198</sup> See e.g., comment letter from the Enhanced Business Reporting Consortium (June 19, 2008).

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environment in which it finds itself. Financial reporting captures some aspects of this but not all and, in fact, financial statements are not currently designed to provide a broader picture of the company and its operations.

From a corporate preparer standpoint, management uses KPIs as key metrics with which to direct the company as part of the strategic planning process both in terms of goal setting and as a way to provide analysis and feedback. In that regard, depending on the degree to which companies are comfortable sharing these metrics with shareholders, communication would be greatly enhanced. By its very nature, such communication would increase the fundamental transparency of the business. Numerous prior studies have shown that greater transparency on the part of corporations reduces the company's cost of capital and no doubt improves market efficiency.<sup>199</sup>

Recognizing this, the SEC encourages extensive discussion of the condition of the business in the MD&A. The SEC, in its 2003 MD&A Interpretive Release, stated that “[o]ne of the principal objectives of MD&A is to give readers a view of the company through the eyes of management by providing both a short and long-term analysis of the business. To do this, companies should ‘identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company’.”<sup>200</sup> In this regard, the SEC noted the importance of disclosures of key performance measures - “when preparing MD&A, companies should consider whether disclosure of all key variables and other factors that management uses to manage the business would be material to investors, and therefore required. These key variables and other factors may be non-financial, and companies should consider whether that non-financial information should be disclosed.” The SEC went on to state that “[i]ndustry-specific measures can also be important for analysis, although common standards for the measures also are important. Some industries commonly use non-financial data, such as industry metrics and value drivers. Where a company discloses such information, and there is no commonly accepted method of calculating a particular non-financial metric, it should provide an explanation of its calculation to promote comparability across companies within the industry. Finally, companies may use non-financial performance measures that are company-specific.” This discussion is intended to give information about the business in a way that is consistent with the manner in which the business is run.

## **Discussion**

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<sup>199</sup> See, Botosan, Christine A., *Disclosure Level and the Cost of Equity Capital*, *The Accounting Review*, Vol. 72, No. 3, 323–349 (July 1997); Botosan, Christine A., *Disclosure and the Cost of Capital: What Do We Know?*, *Accounting & Business Research*, Vol. 36 (Special Issue), 31–40 (2006); and Sumon C. Mazumdar and Partha Sengupta, *Disclosure and the Loan Spread on Private Debt*, *Financial Analysts Journal*, Vol. 61, No. 3, 83–95 (May 2005).

<sup>200</sup> 2003 MD&A Interpretive Release.

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Our recommendation extends beyond a narrow definition of financial reporting to business reporting more generally. We evaluated whether public companies should increase their voluntary disclosure of financial and non-financial performance measures or indicators, such as KPIs. We examined the current practices of public companies and note that many companies are already disclosing some company-specific KPIs in their periodic reports filed with the SEC or in other public statements. However, these company-specific measures may not necessarily be consistently reported by companies from period-to-period, are not necessarily well-defined, and may not be commonly used by other companies in the same industry or engaged in the same activity. As a result, they may not lend themselves to comparisons between and among companies. Therefore, we have evaluated the kinds of KPIs that companies should voluntarily make available, in what format, and whether they should be consistently defined over time. We have found that various groups, within and outside industries, are working on developing industry-specific and activity-specific KPIs in order to improve comparability of companies disclosing on an industry and activity basis.

Accordingly, for KPI reporting to be most effective and improve user understanding, we recommend that companies should consider the following to improve voluntary KPI disclosures:<sup>201</sup>

- Understandability – We believe that a given KPI term, such as "same store sales," would be most useful in evaluating the activity if it had a standard agreed definition as to the particular activity. For that reason, we believe that the SEC should explore ways to encourage private initiatives in various industries for the development of standard KPI definitions. It is presumed that there would be some terms that would be macro in nature that companies from all industries would make use of and thus would be activity-based, but it is assumed that many KPI terms would be industry-specific. Once a term has been defined by industry participants, the SEC and other global regulators should work through these private initiatives to support the use of such term in voluntary disclosures in periodic and other company reports, with such modified or additional disclosures as the SEC and other global regulators deem necessary or appropriate. Companies including KPIs in their periodic and other company reports should be encouraged to use such industry or activity-defined terms and to disclose any differences in their use of terms from any industry or activity-defined and accepted definition. Companies including KPIs in their periodic and other company reports would still have the freedom to use whatever terms they

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<sup>201</sup> We note that the SEC has provided guidance as to some of these matters as well in its 2003 MD&A Interpretive Release as discussed above. The SEC noted that "[t]he focus on key performance indicators can be enhanced not only through the language and content of the discussion, but also through a format that will enhance the understanding of the discussion and analysis."

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wished in describing their businesses, but should make clear any differences between their definitions and those that have been industry- or activity-defined.

- Consistency – Any KPI that is used should be reported consistently from period-to-period, not just for the current period, but for a reasonable number of prior periods as well. Any changes in the definition of a KPI should be disclosed, along with the reasons for the change. If companies voluntarily report KPIs, they should be reported not just for the current period, but for prior periods as well, so that investors can assess the company’s development from period-to-period or year-to-year.
- Relevancy - KPIs that are disclosed should be important to an understanding and tracking of the business or business segments for which they are used and should align with how reporting companies run their business. In many cases, particular KPIs are based on activities that span diverse industries. In some cases, however, KPIs are industry specific because of the unique nature of the way in which businesses are run in that particular industry. To the extent appropriate, we believe KPIs should be activity-based but recognize that particular industry specific KPIs may reflect better the way in which businesses in the particular industry are run.
- Presentability – When companies voluntarily disclose KPIs in their reports and other releases, the disclosure could be included in a separate KPI section in the MD&A or in subsections of parts of the MD&A, such as the general business discussion or the discussion by business segment. Segment reporting of KPIs could be useful to companies that choose to structure their KPIs along business lines. The inclusion of tabular presentations showing current and prior periods also could be useful to companies voluntarily reporting KPIs.
- Comparability – Encouraging companies to use industry- or activity-defined KPIs would enable investors to compare companies within and across industries and would also be quite useful at the industry segment level. Once industry or activity-defined KPIs are available, we would hope that investor interest would encourage companies to use commonly defined KPI terms.

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We understand that some companies may be hesitant about increased disclosure of KPIs because of concern that disclosure of these metrics may compromise competitive information.<sup>202</sup> Neither we nor investors want companies to give away valuable company secrets. We have heard questions about the validity of many of such competitive harm

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<sup>202</sup> We have heard a question as to the liability treatment of KPIs. We understand that there are not unique legal liabilities associated with disclosures of KPIs. Such disclosures would be evaluated in the same manner as any other disclosures made by a public company, whether in a filing with the SEC or in an earnings release.

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claims, particularly where information is widely known within a particular industry. We have heard that there is already so much information about companies that disclosure of unique competitive information would be rare. Nevertheless, we believe that if a particular KPI could result in disclosure of competitively important information, the affected company could decline to disclose it.<sup>203</sup>

Our recommendation provides that the SEC should encourage a private, industry-driven initiative with significant investor involvement to develop best practices that companies could follow in voluntarily developing and disclosing KPIs. Just as financial reporting standards and the recently developed interactive data taxonomy may improve business reporting by creating standardized language, we believe the development of a KPI dictionary, on an industry or activity basis, as appropriate, but also allowing for company-specific definitions, could provide valuable information to investors.

Thus, our recommendation is based on a number of industry-driven initiatives, with significant investor involvement, to develop best practices and common definitions for KPIs that companies could follow in disclosing KPIs. The recommendation suggests that companies, investors, and business reporting consortiums should work together to develop industry-wide and activity-specific KPIs that conform to uniform or standard definitions, as well as company-specific KPIs. Then companies could voluntarily disclose these commonly-defined KPIs in their periodic reports, as well as other disclosure formats such as earnings releases. The recommendation suggests that the KPIs:

- Be clearly and consistently defined to facilitate investors' understanding of the meanings of the KPIs
- Be disclosed, as relevant, on a company and/or segment basis
- Permit cross-company and cross-industry comparisons.

We do not believe that the mandatory reporting of KPIs is desirable at this time. Instead, we are encouraging the SEC to promote the development of commonly recognized and defined KPIs on a relevant activity basis or by industry groups, as appropriate.

#### ***Integration with Other Recommendations***

We believe that the formalization of KPI disclosures through commonly recognized definitions, will enhance the benefits that will come from certain of our other recommendations. For example, disclosing KPIs on company websites would allow investors and other users of the reported information to gain an improved understanding of the prospects for a company and could lead to better capital market pricing.

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<sup>203</sup> See, e.g., comment letters from the Bar Association of the City of New York (April 18, 2008) and the Enhanced Business Reporting Consortium (March 31, 2008).

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## V. Improved Quarterly Press Release Disclosures and Timing

***Recommendation 4.4: Industry groups, including the National Investor Relations Institute, Financial Executives International, and the CFA Institute should update their best practices for earnings releases. Such updated best practices guidance should cover, among other matters, the type of information that should be provided in earnings releases and the need for investors to receive information that is consistent from quarter to quarter, with an explanation of any changes in disclosures from quarter to quarter. Further, the best practices guidance should consider recommending that companies include in their earnings releases their condensed financial statements (including income statement, balance sheet, and cash flow tables); locate GAAP reconciliations in close proximity to any non-GAAP financial measures presented; and provide more industry- and company-specific key performance indicators.***

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***The SEC should consider restating its view that website disclosures regarding GAAP reconciliations for non-GAAP financial measures presented in connection with earnings calls be available on such sites for at least 12 months.***

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### Background

The quarterly earnings release, often the first corporate communication about the results of the quarter just ended, is viewed as an important corporate communication. This communication often receives more attention than the formal Form 10-Q submission which often occurs a week or two later.

The quarterly earnings release is not currently required to contain mandated information other than that required by the application of Regulation G to the presentation of non-GAAP financial measures and the antifraud provisions of the federal securities laws. Industry groups have previously coordinated in developing best practices for reporting companies to follow in preparing their earnings releases. In addition, under SEC rules, companies must furnish earnings releases to the SEC on a Form 8-K. Investors and other market participants have expressed concern about various matters relating to earnings releases, including consistency of information provided in such releases, the timing of such releases in relation to the filing of the applicable periodic report, and the inclusion of earnings guidance in such earnings releases.

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### Discussion

We examined a number of issues relating to the earnings release, including the consistency, understandability, timeliness, and the continued public availability of transcripts or recordings of earnings conference calls. We also considered the consistent

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provision of income statement, balance sheet, and cash flow tables in the quarterly earnings release as well as the positioning and prominence of GAAP and non-GAAP financial measures, and any required GAAP reconciliation, the consistent placement of topics, and clear communication of any changes to accounting methods or key assumptions. We believe the goal for the earnings release should be a consistent, reliable communication form that all investors can easily navigate. In view of our recommendation regarding key performance indicators, we also would encourage the inclusion of activity and company-specific KPIs in earnings releases.

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We are not making a recommendation regarding the issuance of earnings releases at the same time that the related periodic report is filed with the SEC.<sup>204</sup> We understand that the practices of companies in this regard may differ depending on the size of the company and the company's own disclosure practices. For example, we understand that some large companies issue their earnings release at the same time as the filing of their quarterly reports. We also understand that smaller companies tend to wait to issue their earnings releases so that their news would not be eclipsed by news of larger and more well followed companies. While we have heard that some investors have an interest in having the earnings release issued at the same time as the Form 10-Q is filed to avoid duplication of effort in analyzing the company's disclosures, representatives of companies and others have expressed concern about the effect of delays in disclosing material non-public information about the quarter or year end. In addition, investors expressed concern regarding the trading of company stock by executives after the issuance of the earnings release but before the filing of the Form 10-Q and questioned whether executives could be prohibited from engaging in trading until after the Form 10-Q was filed.

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We also heard concerns that companies were not keeping their earnings calls and related information posted on their websites for more than one quarter after the call, thus making quarterly comparisons difficult. We note that the SEC had suggested that companies keep their website disclosures regarding GAAP reconciliations for non-GAAP financial measures presented on earnings calls available on their websites for at least a 12-month period.<sup>205</sup> We are recommending that the SEC reiterate this suggestion.

We briefly discussed the practices of some companies in providing earnings guidance or public projections of next quarter's earnings by company officials, since some believe

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<sup>204</sup> We note that the SEC had received comments on this issue in connection with a prior request for comment to tie the filing of the quarterly report to the issuance of an earnings release. See, SEC, *Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports*, SEC Release No. 34-46464 (Sept. 5, 2002). We also note the comments received in connection with our Progress Report. See, e.g., Bar Association of the City of New York (Apr 18, 2008); Business Wire (Feb. 4, 2008).

<sup>205</sup> See, SEC, *Conditions for Use of Non-GAAP Measures*, SEC Release No. 34-47226 (Jan. 22, 2003).

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that this practice is an important underlying source of reporting complexity and other accounting problems. While we understand the importance of this issue, we are not making any recommendation regarding the provision of quarterly earnings guidance at this time because we note that many others are evaluating the issues arising from the provision of quarterly earnings guidance.

## **VI. Use of Executive Summaries in Exchange Act Periodic Reports**

- ***Recommendation 4.5: The SEC should mandate the inclusion of an executive summary in the forepart of a reporting company's filed annual report on Form 10-K that will also provide a roadmap to the fuller discussion in the report. In filed quarterly reports on Form 10-Q, the executive summary would provide material updates to the executive summaries in the annual or prior quarterly reports. The executive summary should provide summary information, in plain English, in a narrative and perhaps tabular format of the most important information about a reporting company's business, financial condition, and operations, and provide the context for the disclosures contained in the annual report. As with the MD&A, the executive summary should be a concise and balanced discussion that identifies the most important themes or other significant matters with which management is primarily concerned. The executive summary should be required to use a layered approach that would present information in a manner that emphasizes the most important information about the reporting company and include cross-references to the location of the fuller discussion in the annual report. To the extent a similar summary may otherwise be included or useful elsewhere in the report, such as in MD&A, the subsequent section would not need to replicate the discussion, but instead could cross-reference such executive summary. The summary should include page number references to more detailed information contained in the document (which, if the report is provided electronically, could be hyperlinks). The executive summary should be required for all filers, although we believe that the best approach would be to start with executive summaries for large companies and then gradually phase-in executive summaries for smaller public companies.***

### **Background**

We understand that some investors may find it difficult at times to navigate through a company's periodic reports. In fact, complexity and detail in the information presented may cause certain investors to avoid certain types of investments altogether or avoid understanding the businesses in which they have invested. We understand that some

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investors may have difficulty in parsing a reporting company's periodic reports and locating key financial and non-financial information important to an understanding of the company and its business.

We believe that the purpose of the executive summary is to capture in an easily digestible format the essence of anything that the company believes should be important to investors by way of company current performance or management's outlook. Companies should structure the summary to be equally useful to reasonably diligent retail and professional investors alike by using plain language and identifying and highlighting key issues and trends.

We believe that an executive summary should encourage more investors to read and understand the key aspects of the businesses in which they invest and potentially increase participation in the capital markets. The value of an executive summary today, as compared to other summary disclosures that have been used before, is enhanced significantly by the availability of corporate websites and electronic linkages to detailed information on which such summary is based.

Reporting companies are not currently required to include in one place summaries of disclosures in their periodic reports, although a summary of the company and the securities it is offering is a line-item disclosure in Securities Act registration statements. Companies, therefore, are familiar with the concept of summarizing the important aspects of their business and operations at the time they are raising capital. We believe that an executive summary in the forepart of a company's annual Exchange Act report on Form 10-K (with material updates in quarterly Exchange Act reports on Form 10-Q) will facilitate the ready delivery of important information to investors by providing them a roadmap of the disclosures contained in such reports.

### Discussion

We recommend a requirement to include an executive summary in reporting company annual Exchange Act reports on Form 10-K with a required update of material changes to such executive summary in quarterly Exchange Act reports on Form 10-Q. Such reports generally are posted on company websites as well, so that the executive summaries could be electronically available with hyperlinks to the more detailed information in the relevant report. We believe that electronically available executive summaries would further support the enhanced use of corporate websites. See appendix H for an example of a corporate website containing links to information in a company's filed Exchange Act periodic reports, as well as other materials and summary information.

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We understand that a summary report prepared on a stand-alone basis would not necessarily provide investors with information they need in a desired format and that investors would not use such a summary. However, that an executive summary included

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in the forepart of an Exchange Act periodic report may provide investors, particularly retail investors, with an important roadmap to the company's disclosures located in the body of such a report. The executive summary approach may be an efficient way to provide all investors, including retail investors, with a concise overview of a company, its business, and its financial condition. For the more sophisticated investor, an executive summary may be helpful in presenting the company's unique story, which the sophisticated investor could consider as it engages in a more detailed analysis of the company, its business and financial condition.

The executive summary should be as self-contained as possible and therefore should avoid unnecessary detail and "boilerplate" language. However a summary should provide navigation to parts of the document containing related information should the investor wish to see more detail. The executive summary in the Exchange Act annual report on Form 10-K (with material updates in Exchange Act quarterly reports on Form 10-Q) would provide summary information, in plain English, in a narrative and perhaps tabular format of the most important information about a reporting company's business, financial condition, and operations and provide context for the disclosures contained in the annual report.<sup>206</sup> The executive summary should be a concise and balanced discussion that identifies the most important themes or other significant matters with which management is primarily concerned. While not required, some examples of the types of disclosures that a company may provide in its executive summary include summaries of key aspects of company performance, business outlook, and perhaps KPIs that the company has disclosed elsewhere in the report.<sup>207</sup> The executive summary should be required to use a layered approach that would present information in a manner that emphasizes the most important information about the reporting company and include cross-references to the location of the fuller discussion in the annual report or quarterly report (as applicable).<sup>208</sup> To the extent a similar summary may otherwise be included or useful elsewhere in the report, such as in the MD&A, the subsequent section would not need to replicate the discussion, but instead could cross-reference such executive summary. The summary should include page number references to more detailed information contained in the document (which, if the report is provided electronically, could be hyperlinks). The executive summary should be required for all filers, although we believe that the best approach would be to start with executive summaries for large companies and then gradually phase-in executive summaries for smaller public companies.

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<sup>206</sup> The main points in the executive summary should be supported by the more detailed information in the body of the report.

<sup>207</sup> If the disclosures include non-GAAP financial measures, companies would need to comply with the SEC's rules governing the use of non-GAAP measures, including reconciliations to GAAP measures.

<sup>208</sup> Companies also should be encouraged to provide links to related disclosures on a company's website.

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The executive summary in a periodic report might fruitfully use as a starting point the overview that the SEC has identified should be in the forepart of the MD&A disclosure.<sup>209</sup> The MD&A overview is expected to “include the most important matters on which a company’s executives focus in evaluating the financial condition and operating performance and provide context.”<sup>210</sup> A cross-reference to similar disclosures contained in the executive summary should be considered instead of replicating the statements in MD&A.

We believe that the executive summary (and, in the case of quarterly reports, any material updates to a previously provided executive summary in an annual or previous quarterly report) should be required to be included in the forepart of a reporting company’s annual report on Form 10-K filed with the SEC or, if a reporting company files its annual report on an integrated basis (the glossy annual report is provided as a wraparound to the filed annual report), the required executive summary instead could be included in the forepart of the glossy annual report.<sup>211</sup> If the executive summary was included in the glossy annual report, it would not be considered filed with the SEC. We understand that the inclusion of a summary in the body of the periodic report should not give rise to additional liability implications.

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<sup>209</sup> In its 2003 MD&A Interpretive Release, the SEC stated that a good introduction or overview would:

- include economic or industry-wide factors relevant to the company;
- serve to inform the reader about how the company earns revenues and income and generates cash;
- to the extent necessary or useful to convey this information, discuss the company’s lines of business, location or locations of operations, and principal products and services (but an introduction should not merely duplicate disclosure in the Description of Business section); and
- provide insight into material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, on which the company’s executives are most focused for both the short and long term, as well as the actions they are taking to address these opportunities, challenges and risks.

<sup>210</sup> 2003 MD&A Interpretive Release.

<sup>211</sup> If included in the glossy annual report, the executive summary would have to satisfy the same requirements as an executive summary contained in the annual report on Form 10-K.

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## APPENDICES

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## U.S. Securities and Exchange Commission

### **SEC Establishes Advisory Committee to Make U.S. Financial Reporting System More User-Friendly for Investors**

**FOR IMMEDIATE RELEASE  
2007-123**

*Washington, D.C., June 27, 2007* - Securities and Exchange Commission Chairman Christopher Cox today announced the establishment of an advisory committee that will examine the U.S. financial reporting system with the goals of reducing unnecessary complexity and making information more useful and understandable for investors.

The SEC Advisory Committee on Improvements to Financial Reporting will study the causes of complexity and recommend to the Commission how to make financial reports clearer and more beneficial to investors, reduce costs and unnecessary burdens for preparers, and better utilize advances in technology to enhance all aspects of financial reporting.

"Our current system of financial reporting has become unnecessarily complex for investors, companies, and the markets generally," Chairman Cox said. "The time is ripe to review how that system can be made less complex and more useful to investors."

Robert C. Pozen, chairman of MFS Investment Management in Boston and former vice chairman of Fidelity Investments, will chair the SEC's advisory committee. Chairman Cox said he expects between 13 and 17 additional members with varied backgrounds to be named to the advisory committee within the next few weeks.

"In addressing the complexity of the current system, our advisory committee will focus not only on offering better guidance to preparers of financial reports, but also on providing more user-friendly disclosures to meet the different needs of various types of investors," Mr. Pozen said.

SEC Chief Accountant Conrad Hewitt said, "The advisory committee will be studying the very important subject of complexity and transparency in order to help investors better understand the financial statements upon which they rely."

Chairman Cox said that the Commission will direct the advisory committee to conduct its work with a view toward removing practical and structural impediments that reduce transparency or unnecessarily increase the cost of

preparing and analyzing financial reports to the detriment of the investor. The advisory committee will focus on the following areas before making recommendations to the Commission:

- the current approach to setting financial accounting and reporting standards;
- the current process of regulating compliance by registrants and financial professionals with accounting and reporting standards;
- the current systems for delivering financial information to investors and accessing that information;
- other environmental factors that drive unnecessary complexity and reduce transparency to investors;
- whether there are current accounting and reporting standards that impose costs that outweigh the resulting benefits, and
- whether this cost-benefit analysis is likely to be impacted by the growing use of international accounting standards.

As part of its consideration of these areas, the advisory committee will focus on how technology can help address accounting complexity by making financial information more useful to a greater number of investors. Through the power of XBRL, hyperlinks, and other technological advances, the opportunity exists to redesign the financial reporting system to deliver the type and level of information that investors need to access their preferred indicators of company performance.

Chairman Cox noted that Chairman Robert Herz of the Financial Accounting Standards Board (FASB) and Chairman Mark Olson of the Public Company Accounting Oversight Board (PCAOB) have been instrumental in raising awareness about the need to increase the usefulness of the financial reporting system. The advisory committee is looking forward to the continued cooperation and support of both organizations in studying these issues.

The advisory committee will begin its work after additional members are named and the SEC staff files the committee's charter with Congress.

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*Biographical Notes:*

ROBERT C. POZEN

Robert C. Pozen is Chairman of MFS Investment Management®, which manages more than \$200 billion in assets for more than five million investors worldwide. He was named to his current position in February 2004.

Mr. Pozen is an independent director of Medtronic and BCE (Bell Canada Enterprises). In both companies, he has served as a member of the Audit Committee. In addition, he is involved in various non-profit organizations, such as the Council on Foreign Relations and The Commonwealth Fund. He was recently elected as a fellow of the American Academy of Arts and Sciences.

Mr. Pozen was formerly vice chairman of Fidelity Investments and president of Fidelity Management & Research Company, the investment advisor to the Fidelity mutual funds. During his five years as president, Fidelity's assets under management almost doubled. While previously serving as managing director and general counsel of Fidelity Investments, he created Fidelity's Charitable Gift Fund and launched Fidelity's entry into the Japanese mutual fund business.

Prior to joining Fidelity, Mr. Pozen served as Associate General Counsel for the SEC, and taught law and economics at New York University.

During 2002 and 2003, Pozen was the John Olin Visiting Professor at Harvard Law School, teaching interdisciplinary courses focused on corporate governance and financial institutions. In 2003, he served as Secretary of Economic Affairs for Massachusetts Governor Mitt Romney, helping to close the state's large budget gap and re-organize its functions in business and technology, labor and workforce training, and consumer affairs.

Mr. Pozen also served on President Bush's Commission to Strengthen Social Security in late 2001 and 2002. He later developed a detailed proposal to restore solvency to Social Security, known as progressive indexing, that grows benefits more slowly for higher earners while maintaining scheduled benefits for low earners.

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## SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 33-8817; 34-55969; File No. 265-24]

### Advisory Committee on Improvements to Financial Reporting

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Notice of Federal Advisory Committee Establishment and Notice of Meeting.

**SUMMARY:** The Chairman of the Securities and Exchange Commission ("Commission") intends to establish the Securities and Exchange Commission Advisory Committee on Improvements to Financial Reporting ("Committee").

The first meeting of the Committee will be held on August 2, 2007 in the Auditorium, Room L-002, at the Commission's main offices, 100 F Street, NE., Washington, DC beginning at 10 a.m. The meeting will be open to the public. The public is invited to submit written statements with the Committee.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Statements

- Use the Commission's Internet submission form (<http://www.sec.gov/rules/other.shtml>); or
- Send an e-mail message to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number 265-24 on the subject line; or

#### Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Federal Advisory Committee Management Officer, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File No. 265-24. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on its Web site (<http://www.sec.gov/rules/other.shtml>). Comments also will be available for public inspection and copying in the

Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

#### FOR FURTHER INFORMATION CONTACT:

James L. Kroeker at (202) 551-5360 Deputy Chief Accountant, Office of the Chief Accountant, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-6561.

**SUPPLEMENTARY INFORMATION:** In accordance with the requirements of the Federal Advisory Committee Act, 5 U.S.C. App. 2 §§ 1-16, as amended, the Securities and Exchange Commission ("Commission") is publishing this notice that the Chairman of the Commission intends to establish the Securities and Exchange Commission Advisory Committee on Improvements to Financial Reporting (the "Committee"). The Committee's objective is to examine the U.S. financial reporting system, with a view to providing specific recommendations as to how unnecessary complexity in that system could be reduced and how that system could be made more useful to investors.

To achieve the Committee's goals, between 14 and 18 members will be appointed who can effectively represent the varied interests affected by the range of issues to be considered. The Committee's membership may include officers of public companies; board and audit committee members of public companies; accountants and securities lawyers who provide professional services to public companies; and investors, among others. The Committee's membership will be fairly balanced in terms of the points of view represented and the functions to be performed.

The Committee may be established 15 days after the publication of this notice by filing a charter for the Committee complying with the Federal Advisory Committee Act, with the Committee on Banking, Housing, and Urban Affairs of the United States Senate and with the Committee on Financial Services of the United States House of Representatives. A copy of the charter will be filed with the Chairman of the Commission, furnished to the Library of Congress, placed in the Public Reference Room at the Commission's headquarters, and posted on the Commission's Web site at <http://www.sec.gov>. The Committee's

charter would direct it to consider the following areas:

- The current approach to setting financial accounting and reporting standards, including (a) principles-based vs. rules-based standards, (b) the inclusion within standards of exceptions, bright lines, and safe harbors, and (c) the processes for providing timely guidance on implementation issues and emerging issues;
- The current process of regulating compliance by registrants and financial professionals with accounting and reporting standards;
- The current systems for delivering financial information to investors and accessing that information;
- Other environmental factors that may drive unnecessary complexity, including the possibility of being second-guessed, the structuring of transactions to achieve an accounting result, and whether there is a hesitance of professionals to exercise judgment in the absence of detailed rules;
- Whether there are current accounting and reporting standards that do not result in useful information to investors, or impose costs that outweigh the resulting benefits (the Committee could use one or two existing accounting standards as a "test case," both to assist in formulating recommendations and to test the application of proposed recommendations by commenting on the manner in which such standards could be improved); and
- Whether the growing use of international accounting standards has an impact on the relevant issues relating to the complexity of U.S. accounting standards and the usefulness of the U.S. financial reporting system.

The Committee would be directed to conduct its work with a view to enhancing financial reporting for the benefit of investors, with an understanding that unnecessary complexity in financial reporting can be harmful to investors by reducing transparency and increasing the cost of preparing and analyzing financial reports. Our expectation is that the advisory committee would provide specific recommendations and action steps that can be implemented both in the near term and the long term.

The Committee will operate for approximately 12 months from the date it is established, unless, before the expiration of that time period, its charter is extended or renewed in accordance with the Federal Advisory Committee Act or unless the Commission determines that the

Committee's continuance is no longer in the public interest.

The Committee will meet at such intervals as are necessary to carry out its functions. The charter will provide that meetings of the full Committee are expected to occur no more frequently than twelve times per year. Meetings of subcommittees of the full Committee may occur more frequently.

The charter will provide that the duties of the Committee are to be solely advisory. The Commission alone will make any determinations of action to be taken and policy to be expressed with respect to matters within the Commission's authority with respect to which the Committee provides advice or makes recommendations.

The Chairman of the Commission affirms that the establishment of the Committee is necessary and in the public interest.

Furthermore, upon establishment of the Committee, and in accordance with section 10(a) of the Federal Advisory Committee Act, 5 U.S.C. App. 10a, notice is hereby given that the first meeting of the Committee will be held on August 2, 2007 in the Auditorium, room L-002 at the Commission's main offices, 100 F Street, NE., Washington, DC, beginning at 10 a.m. The meeting will be open to the public. The purpose of this meeting will be to discuss general organizational matters, to plan the progression of the Committee's work, and to begin discussions about the sources of unnecessary complexity and the barriers to investor transparency in the U.S. financial reporting system.

By the Commission.

Dated: June 27, 2007.

**Nancy M. Morris,**

*Committee Management Officer.*

[FR Doc. E7-12740 Filed 6-29-07; 8:45 am]

**BILLING CODE 8010-01-P**

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**ADVISORY COMMITTEE ON IMPROVEMENTS TO FINANCIAL REPORTING**

CHARTER

*Preamble*

In accordance with Section 9(c) of the Federal Advisory Committee Act, 5 U.S.C. App. 2 §§ 1-16, as amended, the Chairman of the Securities and Exchange Commission ("Commission") establishes an advisory committee and adopts the following articles to govern the advisory committee.

*Articles*

**A. Official Designation.** The official designation of the advisory committee is "Securities and Exchange Commission Advisory Committee on Improvements to Financial Reporting" (the "Committee").

**B. Objective and Scope of Activity.** The Committee's objective is to examine the U.S. financial reporting system, with a view to providing specific recommendations as to how unnecessary complexity in that system could be reduced and how that system could be made more useful to investors. The Committee should consider the following areas of inquiry:

- the current approach to setting financial accounting and reporting standards, including (a) principles-based vs. rules-based standards, (b) the inclusion within standards of exceptions, bright lines, and safe harbors, and (c) the processes for providing timely guidance on implementation issues and emerging issues;
- the current process of regulating compliance by registrants and financial professionals with accounting and reporting standards;
- the current systems for delivering financial information to investors and accessing that information;
- other environmental factors that may drive unnecessary complexity, including the possibility of being second-guessed, the structuring of transactions to achieve an accounting result, and whether there is a hesitance of professionals to exercise judgment in the absence of detailed rules;
- whether there are current accounting and reporting standards that do not result in useful information to investors, or impose costs that outweigh the resulting benefits (the Committee could use one or two existing accounting standards as a "test case," both to assist in formulating recommendations and to test the application of proposed recommendations by commenting on the manner in which such standards could be improved); and

- whether the growing use of international accounting standards has an impact on the relevant issues relating to the complexity of U.S. accounting standards and the usefulness of the U.S. financial reporting system.

The Committee should conduct its work with a view to enhancing financial reporting for the benefit of investors, with an understanding that unnecessary complexity in financial reporting can be harmful to investors by reducing transparency and increasing the cost of preparing and analyzing financial reports.

**C. Duration.** The Committee shall operate until the earlier of the termination date set forth in Article J below or the date on which the Commission determines that its continuance is no longer in the public interest.

**D. Official to Whom Committee Reports.** The Chairman of the Commission, or his designee, shall receive the advice of the Committee on behalf of the Commission.

**E. Responsibility for Support.** The Commission shall provide any necessary support services for the Committee.

**F. Committee Membership.** The Committee shall be composed of not more than 18 Committee Members who can effectively represent the varied interests affected by the range of issues to be considered. The Committee's membership may include officers of public companies; board and audit committee members of public companies; accountants and securities lawyers who provide professional services to public companies; and investors, among others. The Committee's membership will be fairly balanced in terms of points of view represented and the functions to be performed.

**G. Duties of Committee.** The Committee shall function as an advisory body according to the procedures set forth in the Federal Advisory Committee Act, 5 U.S.C. App. 2 §§ 1-16, as amended. Its duties shall be solely advisory and shall extend only to the submission of advice or recommendations to the Commission. Determinations of action to be taken and policy to be expressed with respect to matters within the Commission's authority upon which the Committee provides advice shall be made solely by the Commission.

The Chairman of the Commission will appoint the Designated Federal Officer ("DFO"). The DFO or her/his designee shall approve or call committee meetings, approve meeting agendas in consultation with the Chairperson, attend all committee or subcommittee meetings, adjourn any meeting when the DFO determines adjournment to be in the public interest, and chair meetings in the absence of the Chair or Vice Chair or as directed by the Chairman of the Commission.

**H. Operating Costs.** The estimated annual operating costs of the Committee in dollars and staff-years are as follows:

- (1) dollar cost: \$1,100,000 per year, for travel, per diem, miscellaneous expenses of Committee members and Commission personnel, and webcasts or other

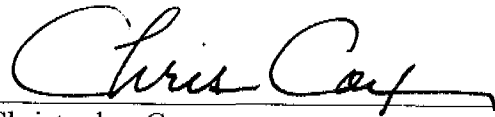
means of making meetings publicly available (this estimate does not include the cost of staff years below); and

(2) staff years: five (5) staff years per year of Commission personnel time.

**I. Meetings.** The Committee shall meet at the call of the Designated Federal Officer, in consultation with the Chairperson. A simple quorum is required for these meetings. The estimated number of Committee meetings is 12 per year. The Committee shall be authorized to establish subcommittees, as necessary, to fulfill its mission, and these subcommittees shall operate under the provisions of the Federal Advisory Committee Act of 1972, as amended. Such subcommittees shall report their recommendations and advice to the Committee for full deliberations and discussion. Subcommittees or working groups have no authority to make decisions on behalf of the chartered Committee nor can they report directly to the Commission or any Federal officers or employees.

**J. Termination Date.** The termination date of the Committee shall be August 2, 2008, which may be extended by amendment of this Article and renewal of this Charter in accordance with the Federal Advisory Committee Act before the termination date.

**K. Filing of Charter.** The Committee is authorized to meet and take action as of the date of the filing of this Charter on July 17, 2007 with the Chairman of the Commission, the Committee on Banking, Housing and Urban Affairs of the United States Senate, and the Committee on Financial Services of the US House of Representatives.



Christopher Cox  
Chairman

July 17, 2007





## U.S. Securities and Exchange Commission

### SEC Chairman Cox Announces Members of Advisory Committee on Improvements to Financial Reporting

#### Committee to Hold First Meeting on August 2

#### FOR IMMEDIATE RELEASE 2007-154

*Washington, D.C., July 31, 2007* - Securities and Exchange Commission Chairman Christopher Cox today announced the appointment of the following members to the SEC Advisory Committee on Improvements to Financial Reporting. The advisory committee, established last month, will hold its first meeting on Thursday, August 2, at 10 a.m. at the SEC's Washington D.C. headquarters.

**Denny Beresford**, Ernst & Young Executive Professor of Accounting, J.M. Tull School of Business, University of Georgia, Athens, Ga. Mr. Beresford is a member of the boards of directors and chairman of the audit committees of Fannie Mae, Kimberly-Clark Corporation and Legg Mason, Inc. He was the chairman of the Financial Accounting Standards Board from 1987 to 1997. Mr. Beresford will represent Fortune 500 audit committees.

**Susan Bies**, was a Federal Reserve Board Governor from 2001 to 2007. Before becoming a member of the Federal Reserve Board, Dr. Bies was Executive Vice President for Risk Management and Auditor at First Tennessee National Corporation in Memphis, Tenn. Dr. Bies will represent banking regulators.

**J. Michael Cook**, retired Chairman and Chief Executive Officer of Deloitte & Touche LLP. Mr. Cook is a member of the boards of directors and chairs the audit committees of Burt's Bees Inc., Comcast Corporation, and Eli Lilly and Company, and is a member of the board of directors and chairs the compensation committee of International Flavors and Fragrances. Mr. Cook will represent Fortune 500 audit committees.

**Jeffrey J. Diermeier**, President and Chief Executive Officer, CFA Institute, Charlottesville, Va. Prior to joining CFA Institute, Mr. Diermeier was global chief investment officer at UBS Global Asset Management. Mr. Diermeier will represent investment professionals.

**Scott C. Evans**, Executive Vice President, Asset Management, TIAA-CREF, New York, N.Y., and Chief Executive Officer of TIAA-CREF's investment

advisory subsidiaries Teachers Advisors, Inc. and TIAA-CREF Investment Management LLC. Mr. Evans is responsible for development of TIAA-CREF's investment products and oversight of the company's more than \$380 billion in assets under management. Mr. Evans will represent pension funds.

**Linda Griggs**, Partner, Morgan Lewis, Washington, D.C. Ms. Griggs will represent securities attorneys.

**Joseph A. Grundfest**, William A. Franke Professor of Law and Business, Stanford Law School, Stanford, Calif., and co-director of the Rock Center on Corporate Governance at Stanford University. Mr. Grundfest joined Stanford's faculty in 1990 after serving for more than four years as an SEC Commissioner. Mr. Grundfest will represent securities attorneys.

**Greg Jonas**, Managing Director, Moody's Investors Service, New York, N.Y. Mr. Jonas joined Moody's from Andersen, where he led the technical functions that supported Andersen's worldwide financial assurance practice. In the 1990s, Mr. Jonas served as the Executive Director of the AICPA Special Committee on Financial Reporting. Mr. Jonas will represent credit rating agencies.

**Christopher Liddell**, Chief Financial Officer, Microsoft Corporation, Redmond, Wash. Mr. Liddell is responsible for leading Microsoft's worldwide finance organization and overseeing accounting and reporting, strategic planning and analysis, treasury, tax, audit and investor relations. Before joining Microsoft, Mr. Liddell was Chief Financial Officer of International Paper Co. Previously, he was Chief Executive Officer of Carter Holt Harvey Ltd., New Zealand's second-largest listed company. Mr. Liddell will represent Fortune 500 technology companies.

**William H. Mann, III**, Senior Investment Analyst, Motley Fool, Alexandria, Va., and the lead advisor for "Motley Fool Global Gains," an investment newsletter service focused on identifying market-beating international stocks. Mr. Mann will represent individual investors.

**G. Edward McClammy**, Senior Vice President, Chief Financial Officer and Treasurer, Varian, Inc., a global technology company in Palo Alto, Calif., that builds leading-edge tools and solutions for diverse, high-growth applications in life science and industry. Prior to joining Varian, Mr. McClammy served in various management roles at Quantum and Lucky Stores, Inc. Mr. McClammy also has worked for Price Waterhouse and the FASB. Mr. McClammy will represent mid-size companies.

**Edward E. Nusbaum**, Executive Partner and Chief Executive Officer, Grant Thornton, LLP, Chicago, Ill. Before becoming CEO, Mr. Nusbaum served as the firm's National Managing Partner of Professional Services, Managing Partner of the Philadelphia Office and National Director of Assurance Services based in New York. Mr. Nusbaum will represent auditors of mid-size and smaller public companies.

**James H. Quigley**, Chief Executive Officer, Deloitte Touche Tohmatsu, New York, N.Y. Mr. Quigley previously served as Chief Executive Officer of Deloitte & Touche USA LLP. Mr. Quigley will represent auditors of large and multi-national public companies.

**Robert C. Pozen**, Chairman, MFS Investment Management, which manages more than \$200 billion in assets for more than five million investors worldwide. Mr. Pozen also is an independent director of Medtronic and serves on the audit committees. Mr. Pozen was formerly vice chairman of Fidelity Investments, sponsor of the Fidelity funds. Prior to joining Fidelity, Mr. Pozen served as Associate General Counsel for the SEC. He will represent mutual funds.

**David Sidwell**, Chief Financial Officer, Morgan Stanley, New York, N.Y. Prior to joining Morgan Stanley, Mr. Sidwell spent nine years at PricewaterhouseCoopers and 20 years at JPMorgan Chase & Co. Mr. Sidwell will represent securities broker-dealers.

**Peter J. Wallison**, Senior Fellow, American Enterprise Institute for Public Policy Research, and co-director of AEI's program on Financial Market Deregulation. Before joining AEI, he practiced banking, corporate and financial law at Gibson, Dunn & Crutcher in Washington, D.C. Mr. Wallison also has served as General Counsel of the U.S. Department of the Treasury, General Counsel to the Depository Institutions Deregulation Committee, White House counsel to President Ronald Reagan and counsel to Vice President Nelson Rockefeller. Mr. Wallison will represent proponents of interactive data for financial reporting.

**Thomas Weatherford**, serves on the boards of directors of Synplicity Inc., Tesco Corporation, Advanced Analogic Technologies, SMART Modular Technologies, Mellanox Technologies and several private companies. Mr. Weatherford retired in January 2003 as Executive Vice President and Chief Financial Officer of Business Objects S.A. Mr. Weatherford will represent small and mid-size company audit committees.

Chairman Cox said, "I am pleased that this exceptionally distinguished group will advise the Commission and the nation on how our increasingly complex financial reporting system can be tamed and made more useful for everyone who relies on it. The committee members each represent key constituencies in our capital markets. I know we can count on them to thoroughly study these issues and recommend improvements that will keep America's financial reporting system as the gold standard for the world."

Chairman Cox previously announced the appointment of Robert C. Pozen, chairman of MFS Investment Management and former vice chairman of Fidelity Investments, as chairman of the advisory committee. Mr. Pozen will be joined by these 16 other members representing investors, companies, and various other entities within the securities markets.

Chairman Cox also announced today that five others will serve as official

observers of the advisory committee, representing the Financial Accounting Standards Board (FASB), Public Company Accounting Oversight Board (PCAOB), Department of the Treasury, International Accounting Standards Committee Foundation, and federal banking regulators. They are:

**Robert Herz**, Chairman, Financial Accounting Standards Board, Norwalk, Conn.

**Charles Holm**, Associate Director and Chief Accountant, Banking Supervision and Regulation, Federal Reserve Board.

**Phil Laskawy**, Chairman of the Trustees, International Accounting Standards Committee Foundation, which oversees the International Accounting Standards Board, London, U.K.

**Mark Olson**, Chairman, Public Company Accounting Oversight Board, Washington, D.C.

**Kristen E. Jaconi**, Senior Policy Advisor to the Under Secretary for Domestic Finance, U.S. Department of the Treasury

The advisory committee will examine the U.S. financial reporting system and provide recommendations about how to improve its usefulness for investors and reduce unnecessary complexity for U.S. companies.

As financial reporting has become more complex, many investors have expressed concerns that it is often difficult to understand the financial reports of companies in which they invest. Likewise, companies have expressed concerns that it is difficult to ensure compliance with U.S. GAAP and SEC reporting rules when preparing financial reports. In fact, during 2006, almost 10 percent of U.S. public companies had to restate prior financial reports due to the discovery of errors in those reports. Restatements are costly to companies, and undermine the confidence of investors in the financial reporting system.

As part of its consideration of these areas, the advisory committee will explore ways to redesign the financial reporting system to take advantage of interactive data and the XBRL computer language for financial reporting. These new technologies, the SEC believes, can help address accounting complexity by making financial information more useful to investors and others who use it.

Further information about the advisory committee and its initial meeting is available on the SEC's Web site at: <http://www.sec.gov/about/offices/oca/acifr.shtml>.

**COMMITTEE BY-LAWS**

**Securities and Exchange Commission  
Advisory Committee on Improvements to Financial Reporting**

**By-Laws and Operating Procedures**

(As adopted on August 2, 2007)

The following By-Laws and Operating Procedures (“By-Laws”) will govern the operations of the Securities and Exchange Commission Advisory Committee on Improvements to Financial Reporting (the “Committee”).

**Section I: Purpose, Organization and Operation**

The purpose of the Committee is to examine the U.S. financial reporting system, with a view to providing specific recommendations as to how unnecessary complexity in that system could be reduced and how that system could be made more useful to investors. The Chairman of the Commission has determined that the establishment of the Committee is in the public interest. The Committee has been formed under the authority of the Federal Advisory Committee Act, 5 U.S.C. App. 2 §§ 1-16, as amended (“FACA”), which governs the creation and operation of advisory committees by federal government agencies, by the filing of its Charter on July 17, 2007 with the Committee on Banking, Housing, and Urban Affairs of the United States Senate and the Committee on Financial Services of the U.S. House of Representatives. Notwithstanding anything to the contrary in these By-Laws, the Committee will operate in accordance with FACA and its implementing regulations, and with its Charter, as the same may be amended from time to time.

**Section II: Members and Official Observers**

The Members of the Committee are appointed by and serve at the pleasure of the Chairman of the Commission as may be appropriate for the accomplishment of the Committee’s purposes and in order to balance the viewpoints required to effectively address those purposes. Membership includes the responsibility to attend Committee meetings personally. The Commission reserves the ability to replace any member who is unable to fully participate in the Committee’s meetings. Alternate members will not be permitted to represent those individuals appointed by the Commission without prior written agreement. Official Observers are invited by the Chairman to serve as official observers of the Committee; they also serve at the pleasure of the Chairman. Official

*This report has been prepared for discussion and deliberation by the full Committee at a July 11, 2008 open meeting. Pending any further action on this report by the Committee, it does not necessarily reflect either the views of the Committee or other members of the Committee. It also does not necessarily reflect the views or regulatory agenda of the Commission or its staff.*

Observers have all rights of Members of the Committee except the right to vote or to make a motion for a vote.

### **Section III: Meetings**

**(A) In General.** The Committee will meet at such intervals as are necessary to carry out its duties. Meetings may be called by the Chairman of the Committee with the approval of the Designated Federal Officer of the Committee appointed in accordance with FACA (“DFO”), or by the DFO. The Chairman of the Committee will preside at all meetings of the Committee, unless the Chairman of the Commission directs the DFO to preside in accordance with FACA. The presiding officer may specify the use of rules of parliamentary procedure consistent with these By-Laws. Subject to such reasonable guidelines and procedures as the presiding officer of the Committee may adopt, Members and Official Observers may participate in a meeting by means of conference telephone or similar communications equipment if all Members and Official Observers can hear one another at the same time and member of the public entitled to hear them can do so.

**(B) Notice.** The Committee will publish a notice of each meeting in the Federal Register at least 15 calendar days before the meeting. The notice will include (1) the name of the Committee; (2) the time, date, place and purpose of the meeting; (3) a copy or summary of the agenda; (4) a statement as to whether all or part of the meeting will be open to the public and, if any part is closed, a statement as to why, citing the specific statutory provisions that serve as a basis for closure; (5) any notice required by Section III(F) if oral public comment is to be excluded; and (6) the name and telephone number of the DFO or other Commission official who may be contacted for additional information concerning the meeting.

**(C) Agenda.** The Chairman of the Committee will draft an agenda for each meeting of the Committee sufficiently in advance of the meeting to permit a copy or summary of the agenda to be published with the notice of the meeting, if required. The DFO must approve the agenda before publication, if required. The Commission staff will distribute the agenda to the Members and Official Observers before each meeting. Items for the agenda may be submitted to the Chairman through the DFO by any Member or Official Observer of the Committee or by any member of the public.

**(D) Voting.** A Member must be participating in a meeting personally, in person or by telephone, to cast a vote. When a decision or recommendation of the Committee is required, the presiding officer will request a motion for a vote. Any Member may make a motion for a vote and vote. No second after a proper motion will be required to bring any issue or recommendation to vote. Committee action based on a vote requires a simple majority of the votes cast at a meeting at which there is a quorum.

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(E) **Quorum.** A quorum will consist of a simple majority of the Members, not including Official Observers.

(F) **Open Meetings.** Unless otherwise determined in advance, all meetings of the Committee will be open to the public. Once an open meeting has begun, it may not be closed for any reason. If, during the course of an open meeting, matter inappropriate for public disclosure arises during discussion, the presiding officer will order such discussion to cease and will schedule it for closed session. All materials brought before, or presented to, the Committee during an open meeting will be available to the public for review or copying at the time scheduled for the meeting. All such materials also will be available on the Commission's web site as soon as practicable afterwards. The Chairman may decide in advance to exclude oral public comment during a meeting, in which case the meeting announcement published in the *Federal Register* will note that oral comment from the public will not be permitted and will invite written comment as an alternative. Members of the public may submit written statements to the Committee at any time.

(G) **Activities Not Subject to Notice and Open Meeting Requirements.** Consistent with FACA regulations, the following activities are excluded from the procedural requirements contained in Sections III(B) and III(F): (a) Preparatory work. Meetings of two or more Committee Members convened solely to gather information, conduct research, or analyze relevant issues and facts in preparation for a meeting of the Committee, or to draft position papers for deliberation by the Committee; and (b) Administrative work. Meetings of two or more Committee Members or subcommittee members convened solely to discuss administrative matters of the Committee or to receive administrative information from a Federal officer or agency.

(H) **Closed Meetings.** All or parts of meetings of the Committee may be closed in limited circumstances in accordance with applicable law. Requests for closed meetings must be submitted by the DFO to the Chairman of the Commission under FACA, generally at least 30 days in advance of the meeting. The appropriate Commission official must determine that closing the meeting is consistent with the provisions of the Government in the Sunshine Act. Consistent with Section III(B)(4), the notice of the closed meeting published in the *Federal Register* must include information on the closure.

(I) **Hearings.** The Committee may hold hearings to receive testimony or oral comments, recommendations and expressions of concern from the public. The Committee may hold hearings at open meetings or in closed session in accordance with the standards in these By-Laws for closing meetings to the public. The Chairman or the Committee may specify reasonable guidelines and procedures for conducting orderly and efficient hearings, such as requirements for submitting requests to testify and written testimony in advance and placing limitations on the number of persons who may testify and the duration of their testimony.

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**(J) Minutes.** The DFO will prepare minutes of each meeting of the Committee and submit them to the Chairman of the Committee for certification of their accuracy. The DFO will distribute copies of the certified minutes to each Member and Official Observer. Minutes of open or closed meetings will be made available to the public upon request, subject to the withholding of matters about which public disclosure would be harmful to the interests of the Government, industry, or others, and which are exempt from disclosure under the Freedom of Information Act. The minutes will include a record of persons present (including the names of Committee Members and Official Observers, names of Commission and committee staff providing support services to the Committee, and names of members of the public who made written or oral presentations); a complete and accurate description of the matters discussed and conclusions reached; and copies of all reports received, issued or approved by the Committee.

#### **Section IV: Officials**

**(A) Chairman.** The Chairman of the Committee is appointed and serves at the pleasure of the Chairman of the Commission to perform the duties specified in these By-Laws. The Committee Chairman will work with the DFO to establish priorities, identify issues that should be addressed, determine the level and types of staff and financial support required and serve as the focal point for the Committee's membership.

**(B) Designated Federal Officer.** The DFO is designated by the Chairman of the Commission and serves as the Federal Government's agent for matters related to the Committee's activities. By law, the DFO must, among other things, approve or call all meetings of the Committee, approve agendas, attend all meetings, and adjourn meetings when such adjournment is in the public interest. In addition, the DFO is responsible for providing adequate staff support to the Committee, including staff to assist the DFO in the performance of the following functions: (1) notifying Members and Official Observers of the time and place for each meeting; (2) maintaining records of all meetings, including subcommittee meetings, as required by law; (3) maintaining the roll; (4) preparing the minutes of all meetings of the Committee and its subcommittees; (5) attending to official correspondence; (6) maintaining official Committee records, including subcommittee records; (7) maintaining a web site for the Committee; (8) acting as the Committee's agent to collect, validate and pay all vouchers for pre-approved expenditures; and (9) preparing and handling all reports, including the annual report of the Committee required by FACA.

**(C) Support Staff.** The Chairman of the Commission has agreed that staff from the Commission's Office of the Chief Accountant and other Divisions and Offices as necessary will be available to the DFO to provide adequate staff support for the

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Committee. The Committee may obtain such other staff or advisory or assistance services appropriate to the goals of the Committee.

#### **Section V: Subcommittees**

The Chairman of the Committee, with the approval of the DFO, may convene subcommittees to support the Committee's functions and may appoint Members and Official Observers to, and Chairs of, any subcommittees so convened. The Chairman will be an *ex officio* member of all subcommittees. Only Members of the Committee will have the right to vote and make a motion for a vote in a subcommittee. No subcommittee will have any authority to provide advice or recommendations (1) directly to the Commission or (2) to be adopted by the Committee without discussion or consideration at an open meeting of the Committee. All activities of the subcommittees will be in compliance with FACA.

#### **Section VI: Records**

All documents, reports and other materials prepared by or submitted to the Committee constitute official governmental records and must be maintained in accordance with FACA's policies and procedures.

#### **Section VII: Expenses**

Expenses related to the operation of the Committee will be borne by the Commission. Expenditures of any kind must be approved in advance by the DFO.

#### **Section VIII: Amendments**

These By-Laws may be amended from time to time by vote of the Members.

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**LIST OF WITNESSES WHO TESTIFIED BEFORE THE COMMITTEE**

**March 13, 2008 Meeting**

***Panel on Materiality and Restatements***

Jack L. Acosta – Sumtotal Systems, Inc.

Steven E. Bochner – Wilson Sonsini Goodrich & Rosati LLP

Manish Goyal – TIAA-CREF

John J. Huber – Latham & Watkins LLP

Steve Meisel – PricewaterhouseCoopers LLP

Elizabeth Mooney – The Capital Group Companies

Barbara Roper – Consumer Federation of America

***Panel on Judgment***

Jonathan Chadwick – Cisco

Randy Fletchall – Ernst and Young LLP

Salvatore J. Graziano – Bernstein Litowitz Berger & Grossmann LLP

John J. Huber – Latham & Watkins LLP

Dennis Johnson – CALPERS

Scott Richardson – Barclay's Global Investors

Scott Taub – Financial Reporting Advisors, LLC

**March 14, 2008 Meeting**

***Panel on XBRL***

Steven E. Bochner – Wilson Sonsini Goodrich & Rosati

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Jeff M. Bodner – Intel Corporation

Mark Bolgiano – XBRL US

Randy G. Fletchall – Ernst & Young LLP

Gregory P. Hanson – ADVENTRX Pharmaceuticals

Christopher Montano – Gridstone Research

John Turner – CoreFiling

**May 2, 2008 Meeting**

***Panel on Substantive Complexity***

Linda Bergen – Citigroup

Mark Bielstein – KPMG LLP

Kevin Conn – MFS Investments

Jeff Mahoney – Council of Institutional Investors

Ben Neuhausen – BDO Seidman, LLP

Brooke Richards – American Express

John Stewart – Financial Reporting Advisors, LLC

***Panel on Standards-Setting Process***

Linda Bergen – Citigroup

Mark Bielstein – KPMG LLP

Kevin Conn – MFS Investments

Jeff Mahoney – Council of Institutional Investors

Ben Neuhausen – BDO Seidman, LLP

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John Stewart – Financial Reporting Advisors, LLC

Lynn Turner – COPERA Trustee

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## EXAMPLES OF SUBSTANTIVE COMPLEXITY

This appendix provides examples of avoidable substantive complexity that currently exist in U.S. GAAP; it is not an exhaustive list. As we acknowledge in chapter 1, some forms of avoidable complexity may be justifiable, for example, due to cost-benefit considerations, or to provide interim guidance while standards-setters develop more permanent literature. Our purpose here is to facilitate thoughtful consideration of the issues raised in the report, rather than to identify individual pronouncements that should be amended or rescinded.

### 1. Measurement Attributes

Examples of measurement attributes include the following:

- Historical cost
- Amortized historical cost
- Fair value
- Fair value less selling costs

### 2. Bright Lines

Examples of bright lines in the form of quantified thresholds and pass/fail models include the following:

#### A. Quantified thresholds

- *Lease Accounting*

Current lease accounting is based on a principle: when a lease transfers substantially all of the benefits and risks of ownership of the property, it should be accounted for as an asset and a corresponding liability by the lessee and the asset is derecognized by the lessor (capital lease); otherwise, rental expense is recognized as amounts become payable (operating lease).

However, to apply this principle, SFAS No. 13 provides the following bright lines for classifying leases as capital or operating. Meeting any one of these criteria results in capital lease treatment.

- The lease transfers ownership of the property to the lessee by the end of the lease term

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- The lease contains a bargain purchase option
  - The lease term is equal to 75% or more of the estimated economic life of the leased property
  - The present value at the beginning of the lease term of the minimum lease payments, excluding certain items, equals or exceeds 90% of the excess of the fair value of the leased property.
- *Consolidation*

For those entities that are not subject to the FIN 46(R) model, “the usual condition for a controlling financial interest is ownership of a majority voting interest, and therefore, as a general rule, ownership by one company...of over 50% of the outstanding voting shares of another company is a condition pointing toward consolidation.”<sup>212</sup> Further, there is a presumption that an investment of 20% - 50% requires equity method accounting. In addition, the equity method is required for investments in limited partnerships unless the interest “is so minor that the limited partner may have virtually no influence over partnership operating and financial policies” (SoP 78-9, *Accounting for Investments in Real Estate Ventures*). In this case, practice has used a 3%-5% bright line to apply the “more than minor” provision. This practice has been acknowledged by the SEC staff in EITF Topic No. D-46, *Accounting for Limited Partnership Investments*.

- *Revenue Recognition*

Bright lines may also be found in revenue recognition literature. One example is SFAS No. 66, *Accounting for Sales of Real Estate*, which provides bright lines for determining the buyer’s minimum initial investment requirements for real estate sales.

- *Business Combinations*

When an SEC registrant undergoes a change in control, the company must reflect the new basis of accounting arising from its acquisition in its stand-alone financial statements (i.e., apply purchase accounting to its own stand-alone financial statements) if the company becomes substantially wholly-owned. “Substantially wholly-owned” is defined such that this push down accounting is prohibited if less than 80% of the company is acquired, permitted if 80% to 95% of the company is acquired, and required if 95% or more of the company is acquired.

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<sup>212</sup> Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, paragraph 2.

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In addition, SFAS No. 141 requires that the purchase price allocation period in a business combination usually not exceed one year from the consummation date.<sup>213</sup>

- *Pension and Other Post-Retirement Employment Benefit Accounting*

SFAS No. 87, *Employers' Accounting for Pensions*, and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, permit the use of smoothing mechanisms that delay the recognition of the effects of changes in actuarial assumptions and differences between actual results and actuarial assumptions. However, these standards contain a bright line as to when the delayed recognition amounts should be recognized.

- *Hedge Accounting*

SFAS No. 133 requires that derivative instruments be recognized at fair value, with changes in fair value recognized in income. However, in an effort to mitigate earnings volatility, SFAS No. 133 permits the use of hedge accounting when a derivative is highly effective in achieving offsetting changes in fair value or cash flows attributable to the risk being hedged. U.S. GAAP, however, does not define "highly effective." Instead, practice has defined "highly effective" as an offset ratio of 80% to 125%.

- *Presentation*

Bright lines are also present in classification requirements. For example, SFAS No. 95 clarifies the definition of "cash equivalents" by stating that "generally, only investments with original maturities of three months or less qualify under that definition" (paragraph 8). Despite use of the word "generally," this bright line is often interpreted stringently.

In addition, SEC Regulation S-X includes bright lines for separate presentation of amounts that would otherwise be included in lines such as revenue, other current assets and liabilities, and other assets and liabilities.

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<sup>213</sup> We note SFAS No. 141 has been superseded by a new FASB standard, SFAS No. 141 (revised 2007), which similarly states in paragraph 51, "...the measurement period shall not exceed one year from the acquisition date."

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- *Disclosure*

Bright lines also exist with respect to the determination of related parties for the purposes of disclosing related party transactions and the identification of segments for the purposes of determining which operating segments require separate presentation.

Further, SEC Regulation S-X includes a number of bright lines regarding requirements to present stand-alone acquiree financial statements, stand-alone equity method investee financial statements, and pro forma financial information, among others. These bright lines are based on the results of certain significance tests, or calculations, defined in Regulation S-X. These significance tests compare the acquiree or investee to the registrant in the areas of assets, investments, and income.

B. Pass/fail tests

- SFAS No. 48, *Revenue Recognition When Right of Return Exists*, requires that where a right of return exists, revenue be recognized at the time of sale only if certain criteria, such as the amount of future returns can be reasonably estimated. Otherwise, revenue recognition is deferred until the right expires or the criteria are subsequently met.
- SFAS No. 133 – if critical terms do not match or if documentation does not comply with the rules, then companies are not eligible to apply hedge accounting.
- SFAS No. 140 contains requirements, all of which must be satisfied, to achieve sale accounting for a transfer of financial assets. Otherwise, the transfer is treated as a secured borrowing with a pledge of collateral.
- EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, identifies a number of criteria that must be met in order for an instrument to be classified as an equity instrument. Failure to meet any of these criteria results in classification as a liability, which is marked to market through income. The criteria do not provide for probability assessments or judgments based on the preponderance of evidence.
- SoP 97-2 related interpretations, and audit firm guidance contain the following pass/fail tests:
  - If vendor specific objective evidence (VSOE) does not exist for all of the undelivered elements of a software sales arrangement, the recognition of

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all revenue from the arrangement must be deferred until sufficient evidence exists, or until all elements have been delivered, unless certain exceptions are met.

- o Extended payment terms usually result in a deferral of revenue. Specifically, when extended payment terms are present, a presumption exists that the vendor's fee is not fixed or determinable, due to the possibility that the vendor may provide a refund or concession to a customer. While there are factors to overcome this presumption, interpretive guidance sets the hurdle to overcome this presumption extremely high, generally resulting in the deferral of revenue until payment is due.

### 3. Qualitative Factors Supported by Presumptions

In place of bright lines in certain circumstances, we have recommended the use of qualitative factors, supported by presumptions. Below are examples:

- *Consolidation Accounting*

Prior to FIN 46(R), the consolidation of special purpose entities (SPEs) hinged on an analogy to guidance that required lessees to consolidate SPE lessors that lacked a substantive investment at risk from an unrelated party. "Substantive" was defined as 3%, at a minimum, with the caveat that a greater investment may be necessary in certain facts and circumstances. Despite this caveat, which would suggest the need for judgment, the presence of the 3% bright line gave rise to numerous structured transactions to achieve a specific accounting purpose.

In December 2003, the FASB issued FIN 46(R), which superseded the 3% threshold. FIN 46(R) requires consolidation in certain circumstances by the party that holds the majority of the risks and rewards of an entity, rather than equity ownership and voting rights. FIN 46(R) contains a presumption that if equity investment at risk is less than 10% of the entity's total assets, the entity is a variable interest entity subject to the FIN 46(R) model, with similar caveats that require additional analysis, judgment and consideration.

- *Contingencies*

SFAS No. 5 provides an example of qualitative factors in U.S. GAAP. SFAS No. 5 establishes recognition and disclosure requirements based on the likelihood – remote, possible, probable – that a liability has been incurred. Although U.S. GAAP does not define these terms, we note audit firms have defined them using quantified presumptions.

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#### 4. Industry-Specific Guidance

1. Below is a list of examples of industry-specific guidance in U.S. GAAP. Note that this list does not reflect all industry-specific guidance or all industries subject to its own guidance.

Industry	Sources
Broadcasting Industry	SFAS No. 63, 139; EITF 87-10; SOP 00-2
Banking and Thrift Industries	APB Opinion No. 23; SFAS No. 72, 91, 104, 109, 114, 115, 147; Technical Bulletin 85-1; FSP 85-24-1; SOPs 90-3, 03-3; EITFs 97-3, 93-1, 92-5, 89-3, 88-25, 88-19, 87-22, 86-21, 85-44, 85-42, 85-41, 85-31, 85-24, 85-8, 84-20, 84-9, 84-4, D-Topics D-78, D-57, D-47, D-39, SEC Regulation S-X – Article 9, SEC Industry Guide; AICPA Auditing and Accounting Guide
Cable Television Industry	SFAS No. 51
Computer Software to be Sold, Leased, or Otherwise Marketed	SFAS No. 2, 86
Contractor Accounting: Construction-Type Contracts & Government Contracts	ARB 43, Chapter 11, ARB 45, SFAS No. 111; SOP 81-1
Development Stage Enterprises	Opinion 18; SFAS No. 7, 95, 154; Interpretation 7; SOP 98-5; AICPA Auditing and Accounting Guides
Finance Companies	SFAS No. 91, 111, 115; SOP 01-6; AICPA Auditing and Accounting Guide
Franchising: Accounting by Franchisors	SFAS No. 45, 141
Insurance Industry	SFAS No. 5, 60, 91, 97, 109, 113, 114, 115, 120, 124, 133, 135, 140, 144, 149, 156; Interpretation 40; FSP FAS 97-1; AICPA Auditing and Accounting Guides; EITFs 99-4, 93-6, 92-9; D-Topics D-54, D-35, D-34, SEC Regulation S-X – Article 7, SEC Industry guide
Investment Companies	SFAS No. 102; FSP AAG INV-1; SOPs 94-4-1, 93-1, 93-4, 95-2, 00-3, 01-1; AICPA Auditing and Accounting Guide; D-Topics D-76 D-74, D-11, SEC Regulation S-X – Article 6,
Mortgage Banking Activities	SFAS No. 65, 91, 114, 115, 124, 125, 133, 134, 140, 149, 156; Technical Bulletin 87-3; SOP 97-1, 03-3; EITF 95-5, 90-21, 87-34, 85-13, 84-19, D-Topics D-10, D-4, D-2
Motion Picture Industry	SFAS No. 139, SOP 00-2
Oil and Gas Producing Activities	SFAS No. 19, 25, 69, 95, 109, 131, 143, 144, 145, 153; Interpretation 33, 36, FSP FAS 19-1,

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	141/142-1, 142-2; AICPA Auditing and Accounting Guide; SEC industry guide, SEC Reg S-X Rule 4-10, SAB Topic 12, FRR Section 406; EITFs 04-6, 04-4, 04-3, 04-2, 90-22
Pension Funds: Accounting and Reporting by Defined Benefit Pension Plans	SFAS No. 35, 75, 102, 110, 135, 149; SOPs 92-6, 94-4, 94-6, 95-1, 99-2, 99-3, 01-2
Real Estate: Sales & Accounting for Costs and Initial Rental Operations of Real Estate Projects	SFAS No. 13, 34, 66, 67, 91, 98, 114, 140, 144, 152; Interpretation 43; SOPs 75-2, 78-9, 92-1, 97-1, 04-2; AICPA Auditing and Accounting Guide; EITF 06-8, 05-3, 98-8, 97-11, 95-7, 95-6, 94-2, 94-1, 91-10, 91-2, 90-20, 89-14, 88-24, 88-12, 87-9, 86-7, 86-6, 85-27, 84-17, SEC Regulation S-X – Rule 3-14, SEC SAB Topic 5N, 5W
Record and Music Industry	SFAS No. 50
Regulated Operations	SFAS No. 71, 87, 90, 92, 98, 101, 106, 109, 135, 142, 144, Interpretation 40; Technical Bulletin 87-2; EITFs 97-4, 92-7; D Topics D-21, D-5; SAB Topic 10
Title Plant	SFAS No. 61, 144

2. Industry-specific exceptions in U.S. GAAP, such as the scope exception for registered investment companies and life insurance entities in FIN 46(R), and for U.S. savings and loan associations, other “qualified” thrift lenders, and stock life insurance companies in SFAS No. 109.
3. Industry practice such as accounting for certain types of inventory at fair value.
4. Industry practice from prior to March 15, 1992 that has been grandfathered under SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*.

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## 5. Alternative Accounting Policies

Examples of alternative accounting policies are as follows:

- SFAS No. 87 and SFAS No. 106, which permit alternatives for amortizing delayed recognition amounts and for measuring return on plan assets.
- SFAS No. 95, which permits alternative presentations of the form and content of the statement.
- SFAS No. 115 (specifically Q&A 35 of the SFAS 115 Implementation Guide), which indicates that companies are not precluded from classifying securities as trading, even if they have no intention of selling them in the near-term.
- SFAS No. 130, *Reporting Comprehensive Income*, permits a choice in presenting comprehensive income. An entity may present other comprehensive income below the total for net income in a single statement, in a separate statement that begins with net income, or in a statement of changes in equity.
- SFAS No. 133, which permits, but does not require, the use of hedge accounting, which, in certain circumstances, may mitigate earnings volatility from marking derivative instruments to market.
- SFAS No. 159, which permits, but does not require, the measurement of certain financial assets and financial liabilities at fair value.
- EITF 88-1, *Determination of Vested Benefit Obligation for a Defined Benefit Plan*, which permits vested benefit obligations to be determined as the actuarial present value of the vested benefits to which the employee is entitled if the employee separates immediately or the actuarial present value of the vested benefits to which the employee is currently entitled but based on the employee's expected date of separation or retirement.
- EITF 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)*, which permits that certain taxes, such as sales, use, and value added taxes, may be presented either on a gross or net basis.
- EITF Topic D-98, *Classification and Measurement of Redeemable Securities*, which permits a choice of methods of accreting instruments to their redemption value.

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- FIN 48, *Accounting for Uncertainty in Income Taxes*, which permits an entity to classify interest and penalties as either interest or taxes.
- FSP AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, which prohibits the accrue-in-advance method, but allows for continued use of one of three other alternatives: direct expense, built-in overhaul, or deferral methods.
- Oil & gas accounting: The two accounting methods followed by oil and gas producers are the successful efforts method and the full cost method. Successful efforts accounting essentially provides for capitalizing only those costs directly related to proved properties; the costs associated with exploratory dry holes are expensed as incurred. Full cost accounting generally provides for capitalizing (within a cost center) all costs incurred in exploring for, acquiring, and developing oil and gas reserves-regardless of whether or not the results of specific costs are successful.
- SAB Topic 5H, *Accounting for Sales of Stock by a Subsidiary*, which permits gains (losses) on sales of stock by a subsidiary to be recognized in income or equity.

## 6. Scope Exceptions

Examples of scope exceptions include:

- SFAS No. 109 scopes out recognition of deferred taxes for undistributed earnings of certain subsidiaries and goodwill for which amortization is not deductible, among others.
- SFAS No. 133 scopes out certain financial guarantee contracts, employee share-based payments, and contingent consideration from a business combination, among others.
- SFAS No. 144 scopes out goodwill, intangible assets not being amortized that are to be held and used, financial instruments, including cost and equity method investments, and deferred tax assets, among others.
- SFAS No. 157 scopes out of its definition of fair value guidance related to employee share-based payments and lease classification and measurement, among others. In addition, the delay in the adoption of SFAS No. 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), effectively scopes out these items for a period of time.

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- FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others*, scopes out contracts that have the characteristics of guarantees, but: (1) are accounted for as contingent rent under SFAS No. 13 and (2) provide for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party, among others.
- FIN 46(R) scopes out employee benefit plans, qualifying special-purpose entities, certain entities for which the company is unable to obtain the information necessary to apply FIN 46(R), and certain businesses, among others.
- SoP 81-1 scopes out certain sales of manufactured goods, even if produced to buyers' specifications, and service contracts of consumer-oriented organizations that provide their services to their clients over an extended period, among others.

## 7. Competing Models

Examples of competing models include:

- Different models for when to recognize for impairment of assets such as inventory, goodwill, long-lived assets, financial instruments, and deferred taxes.
- Different levels of asset aggregation to conduct impairment tests and comply with disclosure requirements, such as asset groups, reporting units, operating segments, and reportable segments.
- Different likelihood thresholds for recognizing contingent liabilities, such as probable for legal uncertainties versus more-likely-than-not for tax uncertainties.
- Different models for revenue recognition such as percentage of completion, completed contract, and pro-rata. Models also vary based on the nature of the industry involved, as discussed in other sections.
- Derecognition of most liabilities such as on the basis of legal extinguishment, as compared to the derecognition of pension and other post-retirement benefit obligations via settlement, curtailment, or negative plan amendment.
- Different models for determining whether an arrangement is a liability or equity.

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**EXAMPLES OF CORPORATE WEBSITE USE**

At our January 11, 2008 meeting, representatives from Microsoft gave a presentation about a proposed new Investor Central portion of its corporate website. The presentation highlighted one innovative way that companies could use their corporate websites to provide financial and other company information to investors. Included in this appendix are screen shots from Microsoft's presentation to us.

Microsoft has since made its Investor Central portion of its website operational. See [www.microsoft.com/msft/IC/default.aspx](http://www.microsoft.com/msft/IC/default.aspx).

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# Summary Report Page-Highlights Performance, Outlook and Opportunities and allows for tiering to segment and financial performance detail

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## Summary Report – Performance at a Glance

### Current Results - Fiscal Year 2007

#### Performance

- Company revenue surpassed \$50B
- Strong customer demand for our new Windows and Office products
- Operating income and EPS both grew double digits
- Good financial results while making investments for future growth
- We used our financial strength to benefit both our shareholders and accelerate growth plans:
  - \$27B of share repurchases and dividends
  - Announced 8 acquisitions, including-\$6B for aQuantive, the largest in company history

#### Outlook

#### Opportunities

#### Key Performance Indicators

Key Performance Indicators	Q4'06	Q4'07
<b>Booking Growth</b>		
Total bookings	>10%	>15%
Core bookings	N/A	>20%
<b>Unearned Revenue Balance (millions)</b>	\$10,902	\$12,646
<b>Contracted Not Billed (billions)</b>	>\$9	>\$10
<b>Product Billing Mix</b>		
OEM	30%	30%
Multi-year licensing agreements	40%	40%
License only	15%	15%
Rest of business	15%	15%
<b>PC Unit Growth</b>	11-12%	11-13%

#### Guidance Fiscal Year 2008

Revenue	\$56.8 B		\$57.8 B
	Low	▲	High
Operating Income	\$22.2 B		\$22.7 B
	Low	▲	High
Diluted EPS	\$1.69		\$1.73
	Low	▲	High

▲ = Wall Street Analyst Expectations

#### Revenue

15%  
Y/Y Growth

#### Operating Income

12%  
Y/Y Growth

#### Earnings Per Share

20%  
Y/Y Growth

#### Download Income Statement

[Excel \(176 kb\)](#) | [XBRL \(87 kb\)](#)

#### MSFT Intraday Chart

#### Operating Segments

- Client
- Server and Tools
- Online Services Business
- Microsoft Business Division
- Entertainment and Devices Division

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# Income Statement detail page-XBRL tagged income statement allows tiering to financial and segment detail

Microsoft

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### INCOME STATEMENTS

(In millions, except per share amounts)

	Three Months Ended June 30,		Year Ended June 30,	
	2007	2006	2007	2006
Revenue	\$13,371	\$11,804	\$51,122	\$44,282
Operating expenses:				
Cost of revenue	3,237	2,130	10,693	7,650
Research and development	1,948	1,861	7,121	6,584
Sales and marketing	3,329	2,822	11,455	9,818
General and administrative	868	1,110	3,329	3,758
Total operating expenses	9,382	7,923	32,598	27,810
Operating income	3,989	3,881	18,524	16,472
Investment income and other	295	377	1,577	1,790
Income before income taxes	4,284	4,258	20,101	18,262
Provision for income taxes	1,249	1,430	6,036	5,663
Net income	\$3,035	\$2,828	\$14,065	\$12,599
Earnings per share:				
Basic	\$0.32	\$0.28	\$1.44	\$1.21
Diluted	\$0.31	\$0.28	\$1.42	\$1.20
Weighted average shares outstanding				
Basic	9,507	10,186	9,742	10,438
Diluted	9,657	10,255	9,886	10,531
Cash dividends declared per common share	\$0.10	\$0.09	\$0.40	\$0.35

[Excel \(176kb\)](#) | [XBRL\(87b\)](#)

[Download Additional Financial Statements for Fiscal Year 2007](#)

Balance Sheets	<a href="#">Excel (15kb)</a>	<a href="#">XBRL (9kb)</a>
Cash Flows	<a href="#">Excel (15kb)</a>	<a href="#">XBRL (9kb)</a>
Segment Revenue & Operating Income	<a href="#">Excel (15kb)</a>	<a href="#">XBRL (9kb)</a>

#### Client Revenue

#### Server & Tools Revenue

#### Online Services Business Revenue

#### Microsoft Business Division Revenue

#### Entertainment & Devices Division Revenue

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H-3

# Revenue/Operating Income Summary –directly from XBRL tagged 10-K with hyperlink to Notes

The screenshot displays the Microsoft investor relations website. The main content area is titled "Revenue/Operating Income Summary". It includes a table comparing 2007 and 2006 data, a "Financial Summary - FY07 Q4" box, and a "Notes to the Financial Statements" section. A large "DRAFT" watermark is overlaid on the page.

**Revenue/Operating Income Summary**

*Revenue Recognition Accounting Policy*

**Summary**

**Fiscal year 2007 compared to fiscal year 2006:**

Revenue growth was driven primarily by licensing of the 2007 Microsoft Office system and Windows Vista, increased revenue associated with SQL Server, Windows Server, and Visual Studio, and increased Xbox 360 console sales. Foreign currency exchange rates did not have a significant impact on consolidated revenue during the year.

(In millions)	2007	2006	Percentage Change Between 2007 and 2006
Revenue	\$51,122	\$44,282	15%
Operating Income	\$18,524	\$16,472	12%

**Financial Summary – FY07 Q4**

- Revenue: \$13.4 billion
- Operating income: \$4.0 billion
- Diluted earnings per share: \$0.31
- Cash returned to shareholders

**Operating Segments**

- Client
- Server and Tools
- Online Services Business
- Microsoft Business Division
- Entertainment and Devices Division

**Notes to the Financial Statements**

**Revenue Recognition Policy**

We account for the licensing of software in accordance with American Institute of Certified Public Accountants' Statement of Position (SOP) 97-2, Software Revenue Recognition. The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. For some of our products, customers receive certain elements of our products over a period of time. These elements include free post-delivery telephone support and the right to receive unspecified upgrade/enhancements of Microsoft Internet Explorer on a when-and-if-available basis. The fair value of these elements is recognized over the estimated life cycle for the Windows XP and previous PC operating systems. For Windows Vista, there are no significant undelivered elements and accordingly, no license revenue is deferred for Windows Vista sales. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product's estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

**Operating Income Growth**

Operating income growth was driven primarily by the increased revenue and decreased costs for legal settlements and legal contingencies, partially offset by increased cost of revenue associated with Xbox 360 and Windows Vista, increased OSB data centers costs, and increased sales and marketing expenses. In July 2007, we expanded our global Xbox 360 warranty coverage to three years from the date of purchase for a general hardware failure indicated by three flashing red lights. As a result, we recorded a \$1.06 billion charge for anticipated costs under the warranty policy, inventory write-downs, and product returns. The increase in sales and marketing expenses was primarily driven by increased headcount-related costs and marketing costs related to recent product launches. Headcount-related costs increased 15%, driven by a 10% increase in headcount over the past twelve months and an increase in salaries and benefits for existing headcount.

**Fiscal Year 2008 Outlook**

Worldwide macroeconomic factors have a strong correlation to business and consumer demand for our software, services, games, and Internet service offerings. We expect a broad continuation in the economic conditions and demand in fiscal year 2008. We also expect continued double-digit revenue growth. Given our product launches in the second half of fiscal year 2007, we expect revenue growth to be higher in the first half of fiscal year 2008 than in the second half. We estimate worldwide PC shipments will grow between 9% and 11%. We do not expect a significant impact from changes in year-over-year foreign currency exchange rates in fiscal year 2008. We expect our operating income growth rate to exceed our revenue growth rate.

[Back to Income Statement](#)

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# Client Operating Segment-Performance & Outlook directly from XBRL tagged 10-K with earnings call slides

Microsoft

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## Client Operating Segment

### Performance

*Fiscal year 2007 compared to fiscal year 2006*

Client revenue increased primarily reflecting licensing of Windows Vista. OEM revenue increased \$1.46 billion or 13% driven by 13% growth in OEM license units while revenue from commercial and retail licensing of Windows operating systems increased \$422 million or 21%. During the year, the OEM Premium Mix increased 16 percentage points to 68%. Based on our estimates, total worldwide PC shipments from all sources grew 10% to 12% driven by demand in both emerging and mature markets.

Client operating income increased reflecting the increased revenue and decreased research and development costs, partially offset by increased Windows Vista product costs and increased sales and marketing expenses for launch-related programs. The decrease in research and development costs reflects the capitalization of certain Windows Vista software development costs and completion of product development on Windows Vista. Headcount-related costs decreased 3%, driven by a 1% decrease in headcount and a decrease in stock-based compensation expense.

### Outlook

#### Strategy

#### Key Performance Indicators

Key Performance Indicators	Q4'06	Q4'07
PC unit growth	11-12%	11-13%
OEM license unit growth	19%	11%
OEM Premium mix	55%	72%
Consumer premium mix	10%	30%
Business premium mix	45%	42%

- Client
- Server and Tools
- Online Services Business
- Microsoft Business Division
- Entertainment and Devices Division

[Back to Income Statement](#)

(In millions)	2007	2006	Percentage Change Between 2006, 2007 and 2006
Revenue	\$14,972	\$13,089	14%
Operating Income	\$11,603	\$10,297	13%

### Client Revenue

**Q4 Summary**

- OEM license unit growth of 11%
- OEM premium mix of 72% driven by sales of Windows Vista Home Premium
- Volume licensing unearned revenue balance grew over 25% due to strength in both renewal and new annuity attach rates

*Growth driven by continued demand for Windows Vista*

### Revenue Guidance Fiscal Year 2008

Annual growth: 9% Low ————— 11% High

▲ = Wall Street Analyst Expectations

### Growth & Focus Areas For Windows Business Group

**Strong PC Unit Growth**

Next 3 Years: More Than Half Global Growth Will Come From Emerging Markets

Upgrade To Premium Within Each Segment

Deliver Premium Offerings To Business & Consumers

**Reduce Usage Of Counterfeit Software**

Worldwide PC Software Piracy Estimated At 35%\*

Windows HL Annuity Penetration Currently Only 23%

Continue Enterprise & Midmarket VL Growth

**Windows Installed Base Will Reach 1B In FY08**

\*Source: IDC Global Software Piracy Study, 2006; Software & Data

### Executive Presentations

- Presentation to Analysts
- Industry conferences

### Download Segment Revenue

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# Client Operating Segment - Strategy links to analyst presentation, industry conferences and hyperlinks to strategy supporting press releases

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## Client Operating Segment

**Performance**

**Outlook**

**Strategy**

Grow window shipments by delivering a compelling value proposition with our OEM partners

- Windows Vista Starter Edition provides unique, low cost offering for emerging markets
- Continue to work with OEM partners on unique and compelling designs

Continue efforts to reduce unlicensed software

- Work with law enforcement to pursue software piracy globally

Offer customers choice among product offerings to suit their needs

- Distinct products for business or home usage
- Provide a tiered product lineup for customers based upon features and price

Drive deeper engagement with large business customers

- Enhance offering for volume licensing customers with additional benefits beyond product upgrades, such as help with manageability and deployment.

**Key Performance Indicators**

Key Performance Indicators	Q4'06	Q4'07
PC unit growth	11-12%	11-13%
OEM license unit growth	19%	11%
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Growth driven by continued demand for Windows Vista

### Revenue Guidance Fiscal Year 2008

Annual growth: 9% (Low) to 11% (High)

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\*Source: IDC Global Software Piracy Study & Research, October 2007

### Executive Presentations

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- Industry conferences

### Download Segment Revenue

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# Hyperlinked Press Release – supports the strategy in the page above

The screenshot shows a Microsoft PressPass website page. The main headline is "Touching People's Lives: Two Million and Counting" with a sub-headline "Microsoft passes the 2 million mark with Windows Starter, using technology innovation to bring digital literacy to beginner PC users in all corners of the world." The article text begins with "BEIJING, April 19, 2007 – Learning to use a mouse in Russia. Connecting a PC to a printer in India. Empowering a small business in Namibia. Opening doors to a child's education in rural Argentina. These are the sorts of challenges Microsoft sought to address with the introduction of Microsoft Windows XP Starter Edition in 2004 – and reinvested in with the introduction of Windows Vista Starter in January 2007. As of today, more than 2 million individuals and families have started their journey into the digital world via a PC with a Windows Starter operating system, which Microsoft designed specifically for first-time PC owners in developing countries and disadvantaged communities." The page includes a left sidebar with navigation links like "Microsoft News", "Corporate Information", and "Related Sites". A right sidebar contains "Related Links" and "Press Releases". A large "DRAFT" watermark is overlaid diagonally across the page.

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# Hyperlinked Analyst Presentations – Kevin Turner’s Client segment transcript from the Financial Analyst Meeting supports strategy

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**2007 Annual Report**

**MSFT Investor Relations**

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**Financial Analyst Meeting 2007**  
July 26, 2007

**Kevin Turner**  
Chief Operating Officer

[Biography](#)  
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**KEVIN TURNER:** All right. Well, good morning, and again welcome, and thanks for being here. We've certainly got a lot to cover with you, and I'm going to dose out the "giving and extending the core" portion that Jeff laid up. As we get into it, the areas specifically I want to touch on first are the corporate desktop value area and then the Windows OEM area, and then I'll wrap it up by pulling together what you heard from Jeff and through this piece on Windows Client, and how we're going to operationalize that and land that in the field, which I think is very important being able to monetize the innovation and how do we land it out there.

And then after I talk we're going to bring up Kevin Johnson, Bob Muglia, Jeff and myself, and then we're going to do a Q&A specifically around growing our core and dose this particular section out.

So as we jump into Windows Client, you know, there's a couple of things I think a year ago that was on everybody's mind—a couple of, four, questions. Number one, will it ship? Number two, will Windows Vista drive revenue? Number three, will Windows Vista deliver a great experience? And, number four, will Windows Vista, particularly for commercial customers, deliver a lower total cost of ownership? And those are the four questions that I really want to frame what I'm going to talk to you about today in the Windows Client area.

You know certainly it was the big issue we've had in Windows. And as you look at it in terms of revenue for us, which we had high expectations for Vista, but also in terms of dollar growth. So year-over-year revenue growth of 24 percent, net revenue growth dollar year-over-year was \$1.7 billion—that's the biggest net revenue growth in Windows history, and, as you look at that, 14 percent was certainly a very good number for us last year. You know, the numbers that we've given you for this next year from a guidance standpoint around GAAP and what our growth is going to be in Windows Client is around 9 to 10 percent growth—so again another healthy year we're forecasting or projecting for FY '08 in the Windows Client area.

But let's look across the customer segments and talk about how do the customer segments and where do we see kind of the results shaping up. Strong results in the consumer market driven by two things: one, certainly a healthy PC market—10 to 12 percent growth this last year. Also, for FY '08, as we look at the PC forecast, and Kevin Johnson and I and our teams collaborating on what do we think it's going to be next year, we're forecasting 9 to 11 percent PC growth. And so when you get those two numbers, it kind of helps some of you who have the modeling how we're going to shape up as it relates to Windows Client from a revenue standpoint this next year.

Customers purchasing our premium version of Windows in FY '07, our premium mix, was 68 percent. And that's a 16-point year-over-year increase as it relates to our premium mix. It's something we feel very good about, and certainly the consumer premium SKUs are driving the majority of that growth, as they were up 27 percent. So when you think about that, that's an important thing.

On the business side, volume licensing, which you all would have seen out of our Q4 numbers, new sales and renewals is growing at the best rate we've seen in many, many years, and that's driven by customers interested in both Windows Vista Enterprise and the ability to get the Enterprise edition deployed, as well as something we affectionately call MDDP, which is the Microsoft Desktop Optimization Pack, and that is where we deliver more value beyond upgrade rights in our Software Assurance offering. So that allows us to be able again to get more value into each node or unit that we sell into the enterprise and commercial space.

So from a modeling standpoint, FY '08 looks like, again, from a revenue standpoint, GAAP is 9 to 10 percent growth, from a PC forecast 9 to 11 percent. And then when you think about the two trends you're dealing with, with a higher percent of the PCs coming through emerging markets, which we have at lower revenue per license, as well as the opportunity that we have from the consumers outgrowing the business mix, both of those are opportunities that cause a strain on our revenue for licenses. So the things that we're doing to offset that we'll talk in a little bit, or at least partially offset that, are around piracy and they're also around the MDDP being able to sell more value into our commercial customers.

So when you think about the experience and testing up the experience and the fact that it delivered the revenue, we shipped the product—Kevin Johnson and Steve have done an amazing job. We had the best launches around the world—over 400,000 customers came to our launches, and certainly something that was the best launch that we've ever had—launch says we've ever had in the history of the company, is something that we feel very good about.

When you look at it, you know, as we designed Windows Vista, our customers told us they needed three things to make sure that we built into the product, and those are three things that I still hear today that customers tell me today that they need to be able to move to Windows Vista. The first one they told us was security and reliability, and that was the number 1 feature in the product. So how did we do? Windows Vista is the most secure operating system we've ever released. In the first 100 days we've had far fewer high-severity vulnerabilities than XP. We've had 12 in XP. We had 25 in XP. And think about the sophistication level of the people that create the vulnerabilities today versus what it was when XP released. It's a far different opportunity today than it was then. Over that same time period, I think you should also note that Windows Vista had far fewer than Apple, as well as any major desktop Linux distributor. And that's something, again, we feel very good about from a security and reliability standpoint. But we're not resting on our laurels; that is something we're going to continue to stay focused on. This is the first operating system we've ever launched with security built in on the front end from a foundation standpoint. And, again, we're going to continue to work on that and improve it as we go forward.

When you think about reliability, Windows Vista has over the built-in tools for diagnostics, hardware, self-healing capabilities, again, it helps increase uptime and lower

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## Detailed KPI schedule – XBRL delivered detailed KPI sheet for analysts to review and download

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### Key Performance Indicators and Key Drivers

Indicator	Period									
	Q1'08	Q2'08	Q3'08	Q4'08	FY08	Q1'07	Q2'07	Q3'07	Q4'07	FY07
<b>Corporate:</b>										
Booking Growth										
Total Bookings			>15%	>25%	>10%		>20%	20%	>15%	
Core Bookings			>20%					25%	>20%	
<b>Unearned Revenues (amounts in millions)</b>										
Unearned Revenue	\$6,806	\$6,838	\$6,901	\$10,902		\$10,097	\$11,861	\$10,283	\$12,646	\$12,646
<b>Unearned Revenue Components</b>										
Volume Licensing Programs	\$5,763	\$5,750	\$5,743	\$7,861		\$6,876	\$6,917	\$6,946	\$9,334	\$9,334
Undelivered Elements	\$2,097	\$2,125	\$2,110	\$2,066		\$2,120	\$3,757	\$1,968	\$1,839	\$1,839
Other Sources	\$946	\$963	\$1,048	\$1,175		\$1,101	\$1,187	\$1,369	\$1,473	\$1,473
<b>Product billing mix (approximate)</b>										
DEM	40%	35%	27%	30%		40%	30%	30%	30%	
Multiuser Licensing Agreements	25%	25%	35%	40%		25%	25%	25%	40%	
License Only	20%	20%	20%	15%		20%	20%	20%	15%	
Rest of Balance	15%	20%	15%	15%		15%	25%	25%	15%	
Enterprise agreement renewal rates - relative to historical range of 66-75%	In-line	In-line	In-line	High end		High end	High end	Exceeded		
<b>Client:</b>										
PC Unit Growth	15-17%	14-15%	12-13%	11-12%	12-14%	8-10%	8-10%	10-12%	11-13%	10-12%
DEM License Unit Growth	18%	15%	16%	19%	17%	11%	10%	20%	11%	14%
DEM Premium Mix	50%	43%	53%	55%	52%	53%	67%	70%	72%	65%
Consumer Premium Mix	4%	7%	9%	10%	3%	16%	27%	30%	30%	27%
Business Premium Mix	46%	42%	44%	45%	44%	43%	40%	40%	42%	41%
<b>Online Services Business:</b>										
<b>Usage Metrics (amounts in millions)</b>										
Windows Live Hotmail Accounts	215	230	241	260		263	268	285	310	
Windows Live Messenger Accounts	185	205	230	243		255	263	278	280	
Live ID's				320					380	
<b>Server and Tools:</b>										
Server Hardware Shipments					11-13%					4-5%
<b>Microsoft Business Division:</b>										
Dynamics Billing Growth						19%	21%	20%	24%	21%
<b>Entertainment and Devices:</b>										
Xbox 360 Unit Sales (amounts in millions)	1.5	1.7	1.8	5	0.9	4.4	0.5	0.7	6.6	
Xbox 360 Unit Sales (LTD) (amounts in millions)	1.5	3.2	5	5	6	10.4	10.9	11.6	11.8	
Total Xbox Live Members (amounts in millions)			>3	>3	>4	>5	>6	>7	>7	
LTD Xbox 360 US Software Attach (source: NPD)	4.1	4.5	4.4	4.4	5.1	5.1	5.7	5.9	5.9	
LTD XBOX360 US accessory attach (source: NPD)	3.1	3	2.9	2.9	2.9	2.8	3	3.2	3.2	

Download the Key Performance Indicators: [Excel \(75 kb\)](#) [XBRL \(87 kb\)](#)

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## Summary Annual Report – Highlights CEO message, company financial highlights, segment highlights and CFO message along with hyperlinks to further detail

### Summary Annual Report – Microsoft Corporation

Our mission is to enable people and businesses throughout the world to realize their full potential. Since our founding in 1975, we have worked to achieve our mission by creating technology that transforms the way people work, play, and communicate. We develop and market software, services, and solutions that we believe deliver new opportunities, greater convenience, and enhanced value to people's lives. We do business throughout the world and have offices in more than 100 countries.

We generate revenue by developing, manufacturing, licensing, and supporting a wide range of software products for many computing devices. Our software products include operating systems for servers, personal computers, and intelligent devices; server applications for distributed computing environments; information worker productivity applications; business solution applications; high-performance computing applications, and software development tools. We provide consulting and product support services, and we train and certify computer system integrators and developers. We sell the Xbox 360 video game console and games, the Zune digital music and entertainment device, PC games, and peripherals. Online offerings and information are delivered through our Windows Live, Office Live, and MSN portals and channels. We enable the delivery of online advertising through our proprietary adCenter® platform.

We also research and develop advanced technologies for future software products. We believe that delivering breakthrough innovation and high-value solutions through our integrated software platform is the key to meeting our customers' needs and to our future growth. We believe that we continue to lay the foundation for long-term growth by delivering new products, creating opportunities for partners, improving customer satisfaction, and improving our internal processes. Our focus is to build on this foundation through ongoing innovation in our integrated software platforms; by delivering compelling value propositions to customers; by responding effectively to customer and partner needs; and by continuing to emphasize the importance of product excellence, business efficacy, and accountability.

#### Message from our CEO, Steve Ballmer

Fiscal 2007 was an important and very successful year for Microsoft. Fueled by the launches of new versions of our flagship Microsoft Windows and Office products, the rollout of the biggest wave of business software in company history, and excellent momentum across a broad range of markets, we reached a significant milestone in 2007 when we surpassed \$50 billion in revenue. One essential difference between Microsoft and any other company in this industry is our willingness to enter new markets and embrace disruptive business trends.

Innovation is a key factor affecting Microsoft's growth. Our model for growth is based on broad adoption of innovation, willingness to enter new markets, and embracing and acting on disruptive trends. We continue our long-term commitment to research and development, including advanced work aimed at innovations, in a wide spectrum of technologies, tools, and platforms; communication and collaboration; information access and organization; entertainment; business and e-commerce; and devices. Increasingly, we are taking a global approach to innovation. This global approach will help us remain competitive in local markets and attract top talent wherever it resides.

Based on our broad focus on innovation and long-term approach to new markets, we see the following key opportunities for growth:

**Consumer technology.** To build on our strength in the consumer marketplace with Windows Vista, the 2007 Microsoft Office System, Xbox 360, Microsoft Windows Live, Windows Mobile, and Zune, we are focused on delivering products that we believe are compelling and cutting edge in terms of design as well as features and functionality. To succeed in consumer technologies, we also are working to define the next era of consumer electronics. In the past, consumer electronics was a hardware-centric business; today, the innovation in consumer electronics devices lies in the software that powers them. This is creating new opportunities for us to deliver end-to-end experiences.

**Software plus services.** Underlying our opportunities in consumer technologies, and in all of our businesses, is a company-wide commitment to fully embrace software plus services. The ability to combine the power of desktop and server software with the reach of the Internet represents an opportunity across every one of our businesses. As we continue to build out our services platform, we will bring a broad range of new products and service offerings to market that target the needs of large enterprises, small and medium-sized businesses, and consumers.

**Expanding our presence on the desktop and server.** While we enjoyed success in fiscal year 2007 with the launches of Windows Vista and the 2007 Microsoft Office System, we see potential for growth by delivering more value per customer. With the planned releases in fiscal year 2008 of Windows Server 2008, SQL Server 2008, and Visual Studio 2008, and the possibility to provide additional value in security, messaging, systems management, and collaboration, we believe we are well-positioned to build on our strength with businesses of all sizes. We will continue to pursue new opportunities in high performance computing, unified communications, healthcare, and business intelligence. Emerging markets are also an important opportunity for us. In fiscal year 2007, we announced the expansion of our Unlimited Potential program as the foundation for our efforts to reach the five billion people around the globe who do not have access to PCs and digital technology today.

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**Financial Highlights**

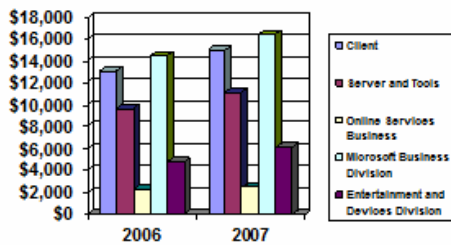
(In millions, except per share data)

Fiscal Year Ended June 30	2007	2006	2005	2004	2003
Revenue	\$51,122	\$44,282	\$39,788	\$36,835	\$32,187
Operating income	18,524	16,472	14,561	9,034	9,545
Net income	14,065	12,599	12,254	8,168	7,531
Diluted earnings per share	\$ 1.42	\$ 1.20	\$ 1.12	\$ 0.75	\$ 0.69
Cash dividends declared per share	\$ 0.40	\$ 0.35	\$ 3.40	\$ 0.16	\$ 0.08
Cash and short-term investments	23,411	34,161	37,751	60,592	49,048
Total assets	63,171	69,597	70,815	94,368	81,732
Long-term obligations	8,320	7,051	5,823	4,574	2,846
Stockholders' equity	31,097	40,104	48,115	74,825	64,912

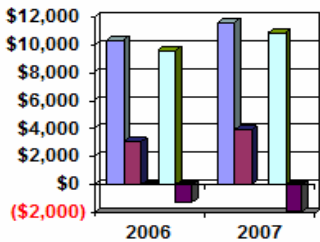
**Segment Revenue/Operating Income**

Microsoft has five operating segments: Client, Server and Tools, the Online Services Business, the Microsoft Business Division, and the Entertainment and Devices Division.

**Segment Revenue (in millions)**



**Operating Income / (Loss)**



Details on the types of products and services provided by each segment can be found in our [SEC Form 10-K](#).

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### Message from our CFO, Christopher Liddell

Fiscal 2007 was a year of \$7 billion of revenue growth, fueled by robust customer acceptance of products in both our emerging and mature businesses, including Windows Vista, Microsoft Office 2007, SQL Server, Windows Server and Xbox 360 consoles. Our core businesses accounted for \$5 billion of absolute revenue growth, with the Business Division, Client and Server and Tools growing 13, 14 and 16% respectively for the year.

Operating income for the year also grew double digits. We were able to achieve this growth while still being able make a number of significant investments in our businesses, such as:

- The launch of over 40 new products into the marketplace as well as a number of updates and enhancements to our online services offerings.
- Continued development of a number of upcoming products releases, such as new versions of Windows Server, SQL Server and Visual Studio
- The enhancement of our online services infrastructure by continuing to refine adCenter and increasing our datacenter capacity
- Necessary investments in Xbox customer satisfaction, and
- We also announced eight strategic acquisitions, including aQuantive, to provide the advertising industry with a world class Internet-wide advertising platform, Tellme for its voice response services, and Softricity for its application virtualization and streaming capabilities.

EPS for the year came in at \$1.42, up 18% over last year which was faster than both revenue and operating income.

Finally, during fiscal 2007 we made significant progress on our strategy of returning cash to shareholders. In July of 2006 we announced authorization for programs to repurchase up to \$40 billion worth of our stock over five years. One year after that announcement, I am happy to say we have passed the half way mark on the programs by repurchasing approximately \$25 billion worth of our stock during the 2007 fiscal year. If you combine the share repurchases we made this year with the \$3.8 billion of dividends paid, we returned about 175% of operating cash flow to shareholders over the fiscal year.



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FOOTNOTES

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(Delivering Financial Information Subcommittee)

Thomas Weatherford  
Former Executive Vice President and Chief Financial Officer  
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Holly Barker  
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